# The Canadian Chartered Accountant

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# The Canadian Chartered Accountant

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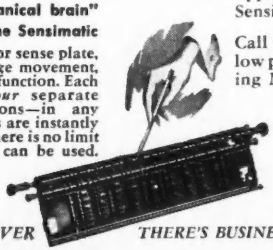

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The Canadian Chartered Accountant

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## COMMENT AND OPINION

### Banff Ho!
### First Call to Annual Meeting

THE 49th annual meeting of The Canadian Institute (it will be awhile before we get used to writing it that way) of Chartered Accountants will be held in Banff, Alberta, Monday to Thursday, September 3 to 6 of this year. During the earlier part of the week various committees of the Canadian Institute will complete their deliberations for the year, and for the members at large four general sessions have been arranged on topics which we are not yet at liberty to announce (because the committee has not yet told us). On Tuesday, September 4, the Premier of Alberta, Hon. E. C. Manning, will, it is hoped, welcome the delegates at a luncheon given by the Government of Alberta, and on the following day Mr. T. Coleman Andrews, president of the American Institute of Accountants, will be guest speaker at the Alberta Institute's luncheon for the members.

And, of course, there will be receptions, tours, and golf on Banff's world-famous links (also mountain climbing, which, however, we mention in parentheses), and the grand finale will be a dinner and dance. The Programme Committee hasn't yet furnished us with a copy of their special programme of entertainment for the ladies, and while it will naturally (they being Albertans) be an excellent one, the mere name of Banff, renowned for its majestic location in the heart of the Canadian Rockies, is by itself an all but irresistible attraction.

Further details will be published in forthcoming issues of *The Canadian Chartered Accountant*, but in the meantime keep in mind the 49th annual meeting of The Canadian Institute of Chartered Accountants at The Banff Springs Hotel, Banff, Alberta, commencing Monday, September 3 and concluding Thursday, September 6, 1951.

### Mr. Abbott Speaks

AND when it is his Budget speech *everyone* listens! By the time this note appears the Finance Minister's 1951 Budget speech delivered on April 10 will, if not forgotten, be displaced in the minds of our readers by matters of more current concern. Alas! it is one of our misfortunes that these notes and comments must be written from five to six weeks before they can be published. As a consequence we seldom dare to be too topical. The Budget, of course, is an exception, having as it does a two-fold impact on accountants, one personal and one professional, whereas most others feel it only in one capacity.

That there would be a need for substantially increased revenues was, of course, well known long before Mr. Abbott rose in the House to announce it. That the additional amount required to be raised by new taxation was no more than $375,000,000 came as a pleasant surprise, since those of us who are not

experts on national finance (and perhaps some of them also) had a much larger figure in mind. Thus it was that the immediate reaction to the announcement of higher taxes was, paradoxically, one of relief. It wasn't as bad as our forebodings.

By the time this comment appears a great deal more will be known about some of the changes in the *Income Tax Act* which Mr. Abbott merely touched on in his address. To what extent the joint recommendations made by the C.I.C.A. and the Canadian Bar Association have been accepted is not known with any certainty at this writing. The Minister did announce, however, that he is proposing certain amendments, and some of these do meet objections raised in the joint recommendations. The right to distribute undivided surpluses on payment of a flat 15% will be extended to all corporations. The rather absurd provision which excluded one corporation from the low rate of tax on its first $10,000 of income if its controlling (70%) shareholder were related by blood, marriage, or adoption to the controlling (70%) shareholder of another corporation, is removed unless the two individuals are shareholders in both corporations. A new departure in administration policy is the right now acknowledged of a salaried taxpayer to deduct certain defined expenses which fall on him personally by the terms of his employment, and also union dues. Mr. Stanley Knowles, M.P., has for several years now been urging the Government to grant the last-mentioned allowance, but credit for the rest belongs, we think, to the continued pressure of this Institute and the Canadian Bar Association. Year after year our joint brief has pointed out that salaried income was not necessarily net income.

The deferment of capital cost allowances on so-called non-essential investments is not so much a matter of tax as of high economic policy, its object being anti-inflationary. There will no doubt be some taxpayers adversely affected by postponement of capital cost allowances, but taken overall, so far as one can judge, the policy has much to commend it.

### Integritas, Scientia, Labor

OBSERVANT readers will have noticed that the seal of the Canadian Institute of Chartered Accountants which adorns the front cover of this issue is somewhat modified in design from the March issue. The same basic design has appeared on every issue of *The Canadian Chartered Accountant* since publication of Vol. 1, No. 1 in July, 1911, though there have been several alterations in its size. The identity of the amateur heraldist who designed the seal these 40 years ago is unknown to us (and if any reader can enlighten us we shall be grateful to him).

The design which first appeared on the magazine was actually a modified version of a yet earlier design of oval shape, which was employed on the front cover of the early Year Books of the Institute. The oval design contained considerably more detail than the modified versions later used on the magazine. The shield, with its scales of justice, its pen of knowledge, and its beaver of industry, were all there, but they were much more surely a scales, a pen, and a beaver, than on the later designs. On the oval seal, however, there were no stars for the Provincial Institutes, but there were instead, lingering on from the Victorian era, innumerable maple leaves, wheat sheaves and what appear to have been *fleurs de lis* and roses. There was also, growing out of the top of the shield and supported by a triangle, a sheaf of enlarged maple leaves.

When the magazine made its initial

appearance the seal appeared in a new round shape. The scales, pen, and beaver remained, and stars were added for the nine Provincial Institutes, these being spaced equally around the scales and pen in the upper part of the shield, and the whole shield was garlanded with maple leaves. The wheat sheaves, *fleurs de lis,* roses, and the sheaf of maple leaves at the top, as well as an immense amount of detail, were deleted in keeping with the simpler artistic concept of the Edwardian era.

The above design was somewhat simplified again in January, 1949, when the garland of maple leaves which surrounded the shield was removed to give greater emphasis to the three symbols on the shield itself. By that time, for whatever reason, the clarity of the symbols had become considerably dimmed, and we frankly admit that for some time we were extremely puzzled as to whether the scales of justice were not in fact bottles of ink, one no doubt green and the other red. Upon the admission of the Newfoundland Institute to the C.I.C.A. in March 1950 an additional star was added to represent it in the shield, and this first appeared in August 1950.

Now with the change in name of the Association, it has again become necessary to change the design to insert the new name, and advantage has also been taken of this necessity to clarify and, it is thought, improve the drawing. Readers can observe the changes for themselves on the front cover. The scales do look like scales, don't they?

## A Compliment

A VERY interesting section of *The Australian Accountant* is entitled "Current Taxation" edited by Mr. J. A. L. Gunn. In the December 1950 issue, in addition to reporting on several Income Tax Appeal Board decisions, he has this to say by way of general comment,—

> At the risk of impertinence, I should like to voice the very highest praise of the decisions of the Canadian Board. For learning and wisdom, expressed with brevity but in limpid sentences, they will match those of any tribunal in the British Commonwealth. One member of the Board usually gives his decisions in French. I have found additional pleasure and profit in reading the decisions in that language. At first I was forced to derive considerable assistance from the English translations which accompany these judgments. Hitherto, my study of French has been concerned with pursuits other than taxation.

# Memorandum on the Accounting Meaning of "Inventory Profits"

By James E. Smyth, C.A.

A comment with special reference to Bulletin No. 5 of the C.I.C.A. Committee on Accounting and Auditing Research

THE MEANING of "inventory profits" is not easily understood and unfortunately there have developed two quite different interpretations of the term; an accounting interpretation and a colloquial interpretation.

Those who use the term in its colloquial sense may be readily detected. They think "inventory profits" have something to do with the pricing policy of business firms. They bog a discussion down with conjecture as to whether prices are set at some fixed mark-up above "original" cost or at some fixed mark-up above "replacement" cost. This memorandum hopes to prove that such speculation is irrelevant.

## Two Senses

In its colloquial sense the term "inventory profits" is taken casually to mean those profits that a rising price level makes possible. As a matter of fact, even in the accounting sense of the term, inventory profits are a part of the consequences of a rising price level; but they develop in a manner quite different from that conceived by those who use the term loosely. "Inventory profits" in the accounting sense are *not at all* those profits that a rising price level makes possible through the ability to increase the price of goods sold above the usual mark-on over original cost.

It will be better to illustrate rather than talk around the point further. Let us suppose a retailer buys at $2.00 an article which he intends to resell at $3.00 (50% mark-on above cost). But prices are rising, the market is buoyant, and when the time comes for this article to be sold, the merchant must pay $2.50 to replace it. Let us suppose also, as may well be the case, that market conditions make it possible for him to sell for $3.75 when in the ordinary course of affairs he would have sold for $3.00. Inventory profits accountingwise are not 75 cents! Instead they arise from the method adopted in valuing goods on hand at the end of the accounting period. Peculiarly enough they relate most directly not to goods sold, but to goods on hand. They are quite a different element of reported income. The 75 cents referred to above is over and above inventory profits defined in the accounting sense and is not included in it.

The accounting definition of inventory profits derives from the fact that the particular valuation placed upon year-end inventories has a direct bearing on the figure for profits for the year. If the physical count of closing inventory is valued higher by accounting method A than by accounting method B, reported profits are greater by the very difference between the alternative inventory valuations where method A is used instead of method B.

### The Accounting Sense of the Term

Inventory profits in the accounting sense are the increase in reported income which follows exclusively from having placed a higher *unit cost* on the items in closing inventory than has been used in valuing the opening inventory. If it were the practice to use from one year-end to the next the same unit costs for identical items in inventory, to the extent that there was a certain number of identical units common to both the opening and closing inventories, we should have eliminated the phenomenon of inventory profits. (Economists would call this a "constant dollar" method of valuing inventories and the accountant's approach to the problem is either LIFO or the base stock method.)

Actually the accounting methods presently in widest use (average cost and FIFO) have a different effect. They subject the *entire volume* of goods on hand at the end of the year (not just the *change* in volume over the year) to a revaluation in arriving at the year-end inventory valuation. And the unit costs used in the valuation are affected by price changes over the year. It is at this point that the accounting concept of inventory profits emerges.

As a means of distinguishing the accounting and the colloquial interpretations of inventory profits a schedule is given below. If the reader can understand the schedule fully in three minutes, he is of superior intelligence; if he can follow it in four minutes, he is above average; and if it takes him seven minutes he and the writer should be friends.

It should be pointed out at the outset that sales are assumed to be 1,300 units, of which 1,000 were acquired at a cost of $4.00 each and 300 units at a later time at $5.00 each. Replacement cost is assumed to be unchanged since the date purchases at $5.00 were made. Also, to simplify the illustration, the inventory accounting method at the beginning of the period is taken to be the same in all three cases, and is varied only in respect of closing inventories.

COMPARISON OF ACCOUNTING AND COLLOQUIAL DEFINITIONS OF INVENTORY PROFITS

| | I<br>Selling price, Original cost +50%<br>Inventory method<br>LIFO | II<br>Selling price, Original cost +50%<br>Inventory method<br>FIFO | III<br>Selling price, Replacement cost +50%<br>Inventory method<br>FIFO |
|---|---|---|---|
| (a) Sales revenue* — 1,300 units | $ 8,250 | $ 8,250 | $ 9,750 |
| *Deduct* cost of goods sold | | | |
| (b) Inventory 1 Jan. 1951 (1,000 units at $4.00) | 4,000 | 4,000 | 4,000 |
| (c) Purchases for Jan. 1951 (1,200 units at $5.00) | 6,000 | 6,000 | 6,000 |
| (d) = (b) + (c) | 10,000 | 10,000 | 10,000 |
| (e) Inventory 31 Jan. 1951 (900 units) | 3,600 | 4,500 | 4,500 |
| (f) Cost of goods sold, (d) — (e) | 6,400 | 5,500 | 5,500 |
| (g) Gross trading margin, (a) — (f) | $ 1,850 | $ 2,750 | $ 4,250 |
| | (1) | (2) | (3) |

* Sales revenue is calculated as follows:

*For cases I and II:*

| | | |
|---|---|---|
| Original cost: 1,000 units at $4.00 | $4,000 | |
| 300 units at $5.00 | 1,500 | |
| | 5,500 | |
| *Add* 50% | 2,750 | |
| | | $8,250 |

*For case III:*

| | | |
|---|---|---|
| Replacement cost: | | |
| 1,300 units at $5.00 | $6,500 | |
| *Add* 50% | 3,250 | |
| | | $9,750 |

It is the difference between (1) and (2) that represents "inventory profits" in the accounting sense; the difference between (2) and (3) is an *additional* increase from quite another cause — pricing policy — and is "inventory profits" in the colloquial sense.

The final figure of $4,250 may now be analyzed as follows:

| | |
|---|---|
| 1. Gross grading margin with (i) pricing policy at original cost + 50% and (ii) LIFO inventory at 31 January | $1,850 |
| 2. Inventory profits in the *accounting* sense, being the difference in valuation of Jan. 31 inventory by FIFO and LIFO ($4,500 — $3,600) | 900 |
| 3. Inventory profits in the *colloquial* sense, arising from pricing policy and being the difference in revenue where goods sold were priced at original cost + 50% and at replacement cost + 50% ($9,750 — 8,250) | 1,500 |
| | $4,250 |

The purpose of LIFO is to eliminate from reported profits the element of inventory profits *in the accounting sense.* (If in practice LIFO occasionally runs into difficulties, that is another matter). Bulletin No. 5 of the Committee on Accounting and Auditing Research states in its conclusions "Thus, *if the selling price of the finished product varies concurrently with the price of the raw material,* the LIFO method of cost determination may be appropriate even though the goods first received are those first disposed of." (Italics added) The writer, not being sure of the answer, wishes merely to raise this question: Can this be an instance where accountants have appropriated the layman's definition of an accounting concept?

# The Function of Courts In Interpreting Tax Statutes

By Erwin N. Griswold, A.M., S.J.D., L.H.D., LL.D.
*Dean, Harvard Law School*

**In the U.S.A. the rule of strict construction of taxation statutes is moribund or worse**

FOR a long time, death and taxes have been regarded as standards of inevitability. But there are those who believe that death is the preferable of the two. "At least", as one of my countrymen recently said, "there is one advantage about death; it does not get worse every time Congress meets."

When I was asked to speak here, I found myself greatly puzzled as to a suitable topic for my talk. I am not in a position to make important disclosures of official policy, as in the case of the Minister of Finance. As a matter of fact, I am under a considerable handicap, for, despite the fact that I have spent more than twenty years in the tax field, I know practically nothing about the Canadian tax law. I suppose I do know something about the United States tax laws, but I have found it difficult to think that you would be interested in a discussion of some of the problems arising under the highly technical provisions of our very complicated statute.

## Formulation of Tax Policy

You have some very real advantages over us. One of these is in the relative ease with which you can change your statute. As I understand it, if the Cabinet agrees, the Minister simply includes the changes in the budget. Either the tax law is changed in the way proposed, except for amendments acceptable to the Government, or there is a new election. There is little or no opportunity for public consideration of the changes or for influence to be brought to bear on them through minority parties in Parliament.

With us, it is very different. Any material change in the tax statute is a matter of great difficulty, involving many months of labour. There are, first, hearings before the Committee on Ways and Means of the House of Representatives. Then the Committee formulates an elaborate report, and the bill goes before the House. In recent years, debate in the House has been severely limited, so that the Committee's bill is usually adopted by the House. Then the bill goes before the Senate Finance Committee, which holds further public hearings. The Finance Committee formulates a report, usually amending the House bill extensively. This then goes before the Senate, where debate is unlimited. There are ordinarily further amendments made in the Senate. After the Senate adopts its version, then

An address to the Fourth Tax Conference of the Canadian Tax Foundation, Dec. 1950

the bill has to be considered by a Committee of Conference made up of members of both Houses. It is here that the final compromises are made.

This is a very difficult and time-consuming process. I do not recommend it to you. On the other hand, I am not sure that we would be very happy with your system. It does have the merit of ease and responsibility but it does not, as far as I can see, give the public much opportunity to be heard.

In what I have said, and in what I am about to say, I know that you will understand that I am not here trying to tell you how you should handle your own affairs. I know that there are factors here which are not familiar to me. I have no doubt that your way is best for you. On the other hand, it is inevitable that my presentation to you should rest upon my own background, and that, as far as taxes are concerned, consists almost exclusively of work with the United States tax law, and before the United States administrative offices and courts.

With all of these things in mind, I have finally decided to try to give a few remarks about the proper function of courts in the interpretation of taxing statutes. It has seemed to me that these observations, based primarily on our experience, might be of some interest to you. On the whole, the developments in the interpretation of our law which I shall outline to you have seemed to me to be good, and indeed, necessary developments. Whether they would be good for Canada, I leave entirely to you.

## The Classic View

I suppose that the classical statement on the interpretation of taxing statutes is that found in the judgment of Lord Cairns in *Partington* v. *Attorney General* (1869), L.R. 4 H.L. 100. The case involved stamp duty in connection with the administration of an estate. In the course of his judgment, Lord Cairns said: ". . . if the Crown, seeking to recover the tax, cannot bring the subject within the letter of the law, the subject is free, however apparently within the spirit of the law the case might otherwise appear to be. In other words, if there be admissible, in any statute, what is called an equitable construction, certainly such a construction is not admissible in a taxing statute, where you can simply adhere to the words of the statute."

Perhaps it is not inappropriate for me to observe that the tax in this case was sustained.

This rule of literal construction of taxing statutes was at first accepted by the Supreme Court of the United States under the income tax law which became effective in 1913. One of the early cases under that statute was *Gould* v. *Gould,* 245 U.S. 151, decided in 1917. The basic question in the case was whether alimony was taxable to the wife as income. In reaching the conclusion that it was not taxable as income (a conclusion which has since been changed by statute), the Court said: "In the interpretation of statutes levying taxes it is the established rule not to extend their provisions, by implication, beyond the clear import of the language used, or to enlarge their operations so as to embrace matters not specifically pointed out. In the case of doubt they are construed most strongly against the Government, and in favour of the citizen."

This is an appealing doctrine. It is surely understandable that it was accepted at the time of *Partington* v. *Attorney General,* and even at the time of the decision in *Gould* v. *Gould*. In this connection, I may point out that the tax involved in that case, for the years 1913 and 1914, was at the rate of two percent.

During the nineteen twenties, this rule was relied upon hundreds of times by

lawyers in their briefs in tax cases, and was frequently accepted by courts with little or no further thought or question.

### Autres Temps, Autres Mœurs

However, in more recent years experience has shown that this rule is not one which can be accepted with generality. I would like to suggest three reasons why the rule of literal construction of taxing statutes is not one which should be accepted invariably by courts today, and then to run briefly through a number of decisions in which the Supreme Court of my country has proceeded on a somewhat different basis.

First, the problem is not as easy as Lord Cairns and Mr. Justice McReynolds made it appear to be. Words, even statutory words, are in fact an imperfect and often uncertain means of conveying thought. It is very rare indeed, if ever, that language can be written which is incapable of construction. There can rarely be a "literal" meaning beyond possibility of question. In the words of Mr. Justice Holmes in *Towne* v. *Eisner* (1918), 245 U.S. 418: "A word is not a crystal, transparent and unchanged, it is the skin of a living thought and may vary greatly in colour and content according to the circumstances and the time in which it is used."

Second, under modern conditions, it can very frequently be said that no construction of a particular taxing provision is actually in favour of taxpayers generally. Many provisions in an income tax statute, for example, work both ways. What is favourable to one taxpayer, may be unfavourable to another. For example, in *Gould* v. *Gould* itself, the decision that the alimony was not taxable to the wife produced by almost necessary consequence the result that the same alimony was not deductible by the husband. We must be very careful that decisions on such matters do not go simply by a rule of thumb in favour of the taxpayer who happened to appear first in court.

Third, as far as taxes are concerned, the nineteenth century, and even 1917, were far simpler times than we are living in today. A rule which may well have been a very fine one when applied to nominal stamp duties or to a two percent income tax may be wholly inappropriate under the conditions of today. In the fiscal year of 1917, the total federal revenue raised in the United States was less than one and one-half billion dollars. We are now headed towards an annual revenue of perhaps sixty billion dollars, or forty times as much. When tax rates are small, it makes little difference if an occasional taxpayer escapes the burden of the tax because of some literal imperfection in the statute. When tax rates are very high, equality of the burden among taxpayers becomes a matter of great importance. The rule of strict construction may be a luxury which the public cannot afford, and which may lead to gross and shocking inequities in the sharing of the tax burden.

### Some Recent U.S. Cases

One of the first cases in which these questions were recognized was *Burnet* v. *Guggenheim* (1933), 288 U.S. 280. That case arose under our gift tax law. The taxpayer there had created a revocable trust before there was any gift tax. After the gift tax went into effect, he released his power to revoke the trust. That is all he did. He made no other transfer of the property. There was nothing in the gift tax statute which dealt with this specific question. It simply imposed the tax on a "transfer of property by gift".

In the Supreme Court, the taxpayer relied strongly on the argument that the statute should be construed in his favour, and that if he did not come within the letter of the statute no tax was due. However, the Court, through Mr. Jus-

tice Cardozo, felt that this argument should not prevail. The difficulty was that a decision in favour of this taxpayer would be, in substance, a decision against another taxpayer who might create a revocable trust while the gift tax was in effect. Mr. Justice Cardozo said, "The construction that is liberal to one taxpayer may be illiberal to others." Of course, it is conceivable that it might be held that neither the creation of a revocable trust nor the release of the power to revoke would constitute a taxable gift. However, that would obviously open a wide avenue of avoidance. The Court did not feel that Congress contemplated such a result. Under the circumstances, it felt that it must decide which of these events was the taxable transfer. When looked at in this view, it is not difficult to see that a termination of the power to revoke is the time when the property is really transferred.

The same point was made by Judge Learned Hand, probably our greatest Federal judge at this time, in *Commissioner* v. *Morris* (1937), 90 F. 2d 962, 964, (C.C.A. 2d). I will not take time to outline the precise question which was before the Court in that case. It involved the taxation of the income from a trust. In reaching his decision, Judge Hand said: "I cannot see that the canon of interpretation which bears against the Treasury in tax statutes should influence us; it so happens that Mr. Morris will have a deficiency to pay in this case, but it is impossible to say that either interpretation will in the end favour taxpayers; sometimes they will gain, sometimes they will not."

### No Exaltation of Artifice

The next case which I wish to mention to you is a rather technical one. It is the case of *Gregory* v. *Helvering* (1935), 293 U.S. 465. It arose under the rather intricate reorganization provisions of our taxing statute, under which no gain or loss or other income is recognized on transfers which meet the statutory definition of a corporate reorganization.

In the *Gregory* case, the taxpayer owned all the stock of the *A* company. Among the assets of the *A* company were certain securities of considerable value. The taxpayer wanted to get these securities into her own name. Obviously, however, a simple distribution of them to her would have been a taxable dividend. So, she undertook to carry out a corporate reorganization which literally met all the requirements of the statute. She caused a new corporation to be organized. Then the *A* corporation transferred the securities to the new corporation, and the stock of the new corporation was issued to the taxpayer. A few days later the new corporation was liquidated and the wanted securities were transferred to the taxpayer.

All of this had been done for the sole purpose of getting the securities into the taxpayer's hands. It complied literally with the terms of the statute, for s. 112(i)(1) of the *Revenue Act* of 1928 provided that "the term 'reorganization' means . . . (B) a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor or its stockholders or both are in control of the corporation to which the assets are transferred, . . . ."

In the lower Courts, the United States Circuit Court of Appeals for the Second Circuit, in New York, it was held that the transaction did not come within the purport of the statute, even though it was within its literal meaning. In reaching this result, Judge Learned Hand said: "It is quite true as the Board [of Tax Appeals] has very well said, that as the articulation of a statute increases, the room for interpretation must contract; but the meaning of a sentence may be

more than that of the separate words, as a melody is more than the notes, and no degree of particularity can ever obviate recourse to the setting in which all appear, and which all collectively create."

This conclusion was affirmed by the Supreme Court. It held the transaction taxable. In doing so, it said: "The rule which excludes from consideration the motive of tax avoidance is not pertinent to the situation, because the transaction upon its face lies outside the plain intent of the statute. To hold otherwise would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose." Thus, the *Gregory* case established that a transaction would not come within the statutory provision, despite compliance with its literal meaning, unless it involved a genuine business purpose. This clearly introduces some uncertainty into the application of the statutory language. But it also recognizes that the statutory language must be given an effective construction in accordance with the obvious basic purpose of Congress.

### Resolving Doubts

The next case which I would mention to you is *White* v. *United States* (1938), 305 U.S. 281, 292. In that case, the question was whether a gain derived when a corporate bond was paid off at maturity was a gain on the "sale or exchange" of the bond. Once again, it was argued on behalf of the taxpayer that all doubts should be resolved in favour of the citizen. The transaction of payment simply wasn't a "sale or exchange". But Mr. Justice Stone gave this contention short shrift. He said: "We are not impressed by the argument that, as the question here decided is doubtful, all doubts should be resolved in favour of the taxpayer. It is the function and duty of courts to resolve doubts. We know of no reason why that function should be abdicated in a tax case more than in any other case where the rights of suitors turn on the construction of a statute and it is our duty to decide what the construction fairly should be."

There are two further cases that I would like to mention to you, both decided in 1940.

The first of these is *Helvering* v. *Horst,* 311 U.S. 112. In that case, a taxpayer was the owner of a corporate bond. Shortly before the interest date, he cut the interest coupon from the bond, and gave it to his son. Thereafter, the son collected the coupon when it was due. The question was whether the income which the coupon represented was taxable to the father or to the son. I understand that this is a question which is expressly covered in your statute. However, there was nothing in our law which specifically dealt with it. The nearest statutory provision was the general language of s. 22(a) of our Code, which simply taxes the income "of every individual" to him. Once again, the Court was not impressed by the fact that there was no clear or specific statutory provision imposing the tax on the donor in such a case. It felt that the taxpayer had derived sufficient benefit from the control of the income through diverting it to his son to make it proper to tax the income to him. As Mr. Justice Stone said, "Common understanding and experience are touchstones for the interpretation of the revenue laws."

### A Decision Which Created Consternation

The next case, and the last one which I shall outline to you, is the rather famous and leading case of *Helvering* v. *Clifford,* 309 U.S. 331, also decided in 1940. This case involved the income of a trust. A man had created the trust for his wife. He made himself trustee. The trust was irrevocable, but by its terms it had a duration of only five years.

At the end of the five years, the corpus of the trust reverted to the husband outright. During the five years, he had discretion either to pay the income to the wife or to accumulate it for her. Any undistributed income at the end of the five-year period had to be paid to the wife outright. The trust was not a sham, but it was a short-term irrevocable trust created by a husband for his wife, with the husband as trustee.

There was nothing in our statute, and there is not now, which expressly taxed such income to the husband. There is a section under which the income of a revocable trust is taxable to the grantor, but this also applied where the income may be used for the benefit of the grantor. But this was not a revocable trust, and the income for the five-year period could not be used for the benefit of the grantor. It must go, not later than the end of the five-year period, to the wife. The trust was created in the confident anticipation that the income would be taxable to the wife and not to the husband.

However, when the case came to the Supreme Court, the decision was that the income was taxable to the husband. This created a certain amount of consternation at the time, but I think it is now accepted without serious question. The Court held that under the circumstances the husband was in substance the owner of the property. The Court felt that the generalized language of s. 22(a) was sufficient. For taxing purposes, the husband remained "the owner of the corpus".

### Strict Construction Dead in U.S.A.

These decisions, and I could add many more, show that the old time rule of strict or literal construction of taxing statutes is a thing of the past in the United States. Instead of regarding itself as a merely mechanical applier of plain language, the Court has felt that it was its proper function and duty to undertake to construe the language so as to get to the basic meaning of Congress. It has recognized that it is not feasible to spell out in detail all the possible situations which may eventually be presented to courts. On many subjects, Congress must and should speak in rather general terms, and it then becomes the function of the courts to give those terms vitality, to interpret them in such a way, as applied to specific situations, as will best effectuate a basic and general objective of Congress, which is to raise revenue under a fair and equitable taxing system.

### Courts Must Exercise Discretion

This places a grave responsibility on the courts, and one which it is by no means easy for them to meet. I do not think that it is fair or accurate to say that it makes the courts into a legislature, or indeed into a super-legislature. The notion that courts act merely mechanically, and have no function but to declare the law as it has been enacted by the legislature is not one which will withstand analysis. It is inevitable that the courts will have to exercise discretion and judgment. Indeed, that is what they are for. It is true that their discretion will be effective over much narrower points than that of the legislature; and it is also true that the basic policy decisions must be made by the legislature.

This was well put by Mr. Justice Frankfurter in a Cardozo lecture delivered before the Association of the Bar of the City of New York in 1947. This was entitled "Some Reflections on the Reading of Statutes" (47 Col. L. Rev. 527, 534). In the course of his remarks he said:

> The vital difference between initiating policy, often involving a decided break with the past, and merely carrying out of formulated policy, indicates the relatively narrow limits within which choice is

> fairly open to courts and the extent to which interpreting law is inescapably making law. . . . There are varying shades of compulsion for judges behind different words, differences that are due to the words themselves, their setting in the text, their setting in history. In short, judges are not unfettered glossators.

This duty of courts to exercise judgment stands out clearly in the construction of taxing statutes. The fact that they do this may introduce an element of uncertainty into the taxing law. It does mean, in the United States, that tax lawyers have to know not only what the law is now, but should have a good basis for judgment as to the developments which may occur in the future. The tax advisor with us has to keep his client from engaging in transactions which though apparently within the literal terms of the statute are so doubtful, or so artfully contrived, that he feels that they will not stand the eventual scrutiny of the courts. I have no doubt that this has contributed greatly toward the objective of a fairer and more equitable tax system.

### Is U.S. View Applicable to Canada?

Whether this development has any application for Canada, I do not know. I find myself wondering, though, whether you will not have to experience some of the same sort of participation by the courts in the working out of the details in your taxing statutes.

For many years we were told that the reason the Canadian tax system was such an excellent one was because it provided for the exercise of discretion by the administrative authorities on a very large scale. We were told that your tax officials were of very high calibre, and that because they exercised their great powers wisely you were able to administer soundly a relatively rigid taxing statute.

As I have looked at Canadian tax cases, I have come across a number which, it seems to me, might have yielded to this approach. I speak with great diffidence, for I am really not qualified to speak about Canadian tax law. But these are both decisions which strike me as ones in which the courts might have looked to the larger meaning of the statute instead of to its literal words.

### E.g., the Trapp Case

The first of these decisions is *Trapp* v. *Minister of National Revenue* (1946), Ex. C.R. 245. You are undoubtedly familiar with this case so I will not undertake to state it to you. As I see it, the Court there felt that the words "annual net profit . . . received" were so clear that they could not be applied to an accrual system of accounting, despite the obvious practicalities of the situation and long continued and widespread practice. I must confess that, to me, the word "received" is not as clear as this, particularly when applied to such a concept as "net profit" in the context of a taxing statute. This is a situation, it seems to me, where an organic construction might have been well warranted.

It is true, as I understand it, that that result has since been changed by statute. You may well say that this is the way to handle these problems. If the language is too narrow when read literally the court should leave it alone and let Parliament deal with the problem. But how about all of the past cases? Under the decision in the *Trapp* case many thousands of tax returns must have been wrong. I cannot believe that they were all revised in accordance with the decision. I find it difficult not to suspect that the *Trapp* decision must have been honored in the breach in a great many cases. And where it was followed and applied, the problems involved in a change from an accrual basis to a cash basis, and then back to an accrual basis

after the adoption of the statute, must have been very difficult indeed. All of this, as I see it, might very readily have been avoided, and with advantage to all concerned, by a recognition of the fact that the word "received" when used in a taxing statute is necessarily a word of rather complex meaning.

### And the Supreme Court Too!

The other case which I would mention here is *Minister of National Revenue* v. *Great Western Garment Company Ltd.*, [1949] C.T.C. 343, decided by the Supreme Court of Canada, just a little over a year ago. That decision actually involves the construction of an order in council rather than of a statute, but I do not think that the principle is different. The order undertook to prevent the deduction of any salaries which constituted an increase in rate above salaries which were being paid when the order in council went into effect. In this case, the company had entered into agreements to pay salaries free of income tax. Consequently, when tax rates went up, the overall payment was increased. The Court held, with a close division, that the increased payment was deductible. This strikes me as (a) an undesirable result when the realities of a war-time economy are taken into account, (b) a result which is hardly fair to the great mass of other persons who complied with the spirit of the order, and (c) a result which was by no means necessary or inevitable, and which might have been avoided if the Court had felt more free to take a broader view of its function in construing the provision before it.

A number of years ago, my predecessor, James M. Landis, wrote a brilliant article on "Statutes and the Sources of Law". For us, I think that he was prophetic when he wrote: "The present attitude responsible for our cavalier treatment of legislation is certain to be a passing phenomenon. The consciousness that the judicial and legislative processes are closely allied both in technique and in aims will inevitably make for greater interdependence in both . . . Grammatical interpretation is giving way to functional construction."

It may be that the Bar and the accounting profession can make a significant contribution to the development of the tax law by recognizing that the courts have a greater function in the construction of the taxing statutes than was generally recognized a generation ago.

# Taxation Statutes: Strict or Functional Interpretation?

By Stuart Thom, B.A., LL.B.

**Will Canadian Courts follow the example of Britain or the U.S.A. in their approach to taxation statutes?**

DEAN GRISWOLD'S approach to the interpretation of taxing statutes will not surprise those who have been following legal developments in the tax field. His philosophy is nevertheless disturbing and unwelcome to many lawyers and no doubt to many accountants. Until the last decade there was an unbroken line of judicial authority in Canada and Great Britain supporting the proposition that a taxing Act must be strictly interpreted. Frequently the Courts went to great lengths — some would say to extremes — to protect the devices of wealthy taxpayers for avoiding the full impact of the law. It was said repeatedly that a man was entitled to order his affairs so as to pay the minimum amount of tax required by the law and that the Courts would neither assume, nor find in the words of the legislation, an intention by Parliament to levy a dollar of tax beyond what was imposed by explicit words. The able and penetrating discussion by Melville Pierce in the issue of *The Tax Review* for October, 1950, of the success which attended the efforts of the Vestey family to mitigate tax to which it was exposed, shows the type of case and the manner in which the strict construction rule has been applied.

An ironic footnote to the vigour of the language used on occasion by Judges in defence of taxpayers is the reflection that the onus is always on the taxpayer to show why he should not pay taxes. The Crown has no obligation in the first instance to prove that tax is payable, but by the simple administrative process of issuing a notice of assessment places itself in a position of incalculable advantage. The obligation on the taxpayer to negative the *prima facie* liability is a potent counter-balance to any embarrassment which may be caused the Crown by the principles of interpretation followed by the Courts.

### Autres Temps, Autres Mœurs

Dean Griswold suggests that the rule of strict interpretation is no longer entitled to its former dominant position. In so arguing he is applying to the law of taxation a philosophy which prevails in many other fields, such as health, labour, and family and social welfare. Since the beginning of the century there has been an increasing realization of the interdependence of all the citizens of the State, and the individual is no longer permitted to conduct his affairs as though he alone could determine to whom he

was responsible and to what extent. Moreover, the immense extension of the activities of government requires a great deal of money. Parliament in this country, as well as in Great Britain, although not to the same extent, is committed to the policy of levelling out inequalities of wealth. These may be rather obvious comments. The cumulative effect is that the law of taxation no longer stands on the same footing as other legislation, such as the *Wills Act,* which govern the rights and property of the individual. Taxation has become the engine of a vast programme of social change to say nothing of the enormous cost of providing a defence against aggression. Principles which were developed at a time when taxation was on the scale required for only a modest establishment of government will not survive unless justified by reasons of current value.

The extent to which considerations such as the foregoing have influenced judicial thinking in Great Britain is exemplified by the following remarks of Lord Simon, L.C. in *Latilla* v. *Inland Revenue Commissioners* [1943] A.C. 377. The Lord Chancellor said:

> My Lords, of recent years much ingenuity has been expended in certain quarters in attempting to devise methods of disposition of income by which those who were prepared to adopt them might enjoy the benefits of residence in this country while receiving the equivalent of such income without sharing the appropriate burden of British taxation. Judicial *dicta* may be cited which point out that, however elaborate and artificial such methods may be, those who adopt them are "entitled" to do so. There is, of course, no doubt that they are within their legal rights, but that is no reason why their efforts, or those of the professional gentlemen who assist them in the matters, should be regarded as a commendable exercise of ingenuity or as a discharge of the duties of good citizenship. On the contrary, one result of such methods, if they succeed, is of course to increase *pro tanto* the load of tax on the shoulders of the great body of good citizens who do not desire, or do not know how, to adopt these manoeuvres.

The underlying reasons which were considered to justify the principles expressed by the House of Lords in the case of *Partington* v. *Attorney General,* referred to by Dean Griswold, are not set out in the judgments because they were taken for granted. Taxation was regarded as an evil, necessary but not to be encouraged, and the individual was not considered to have any extensive obligation to the community around him. This was the accepted thinking of men in whom the spirit of 19th century *laissez-faire* still burned brightly. The liberties of the individual included then a great many things that are not included today. Taxation was regarded, quite rightly, as a potent threat to such rights of the individual as the full enjoyment of what he had earned or inherited. Today, those who seek to maintain such ancient liberties have a very small audience indeed. If the rules developed in the last half of the 19th century are to survive into the last half of the present century, they will require more persuasive reasons.

### A Greater Evil

One possible reason is the contention that the Courts by adopting a functional interpretation of tax legislation thereby promote the socially desirable result that no particular individual shall escape payment of tax because of some scheme or device. It is assumed that Parliament meant to impose its taxes equitably upon all and accordingly it is said that the Courts are at liberty so to interpret the law that none escape by a trick. Mr. Pierce in his article already referred to quoted from a judgment of Lord Normand in the House of Lords, who raised this argument so that he might reject it, and said:

> Tax avoidance is an evil, but it would be the beginning of much greater evils if the Courts were to overstretch the language of the statute in order to subject to taxation people of whom they disapproved.

Lord Normand's argument is unassailable provided there is agreement on what constitutes tax avoidance. To him it meant going through a gap in the law as devised and written by Parliament. There is nothing more misleading, however, than to use the language apt for the description of a brick wall when dealing with ideas. A brick wall is a physical thing with qualities and dimensions about which there can be no dispute. Ideas and concepts are something else altogether and the resemblance between a tax law and a brick wall with holes in it is not too helpful. The law is words, which are ideas, and, as Dean Griswold points out, are not unchanging but vary in content according to the circumstances. The gap in the law through which the Vesteys, for example, passed to escape taxation existed because the ultimate appeal court said that it was there. The Judges of several other courts had said that it was not there, but they did not have the last word. The House of Lords put limits on ideas which Parliament had expressed in certain words and as a result tax avoidance within the law was possible.

### The Borderline Case

Legal tax avoidance (as distinguished from illegal avoidance by such means as false statements) is essentially a problem of the borderline case. Until the day arrives, probably not too far distant, when the Government takes everything, there will be unavoidably cases which will tip one way or another according to the opinion of one or more Judges. There may be occasions when, consciously or otherwise, the judicial mind will be influenced by feelings of disapprobation of the activities of the taxpayer whose affairs are under review. For that matter, there is no presumption that tax avoidance as understood by, for example, Lord Normand, will invariably arouse the ire of the court. In England, at least, judgments can be found which suggest that the ingenuity of the taxpayer's scheme and the subtlety of the arguments supporting it were being applauded. It is doubtful, however, if there is any judgment in which it was said specifically that because the court did not like what the taxpayer was doing, it proposed to stretch the law to defeat his purpose. The expressed intention is always to determine the true meaning and effect of the words of Parliament and only incidentally to suppress tax avoidance. Lord Normand's reason for preferring the strict approach to the problems of interpretation cannot be regarded as an adequate answer.

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### Taxation Is a Practical Matter

Another reason develops from the consideration that taxation is a practical matter and that there is much to be said for approaching a tax Act from that point of view. This has been done in a recent article which appeared in the *Tax Law Review* of January 1951. The author, Mr. Robert N. Miller of Washington, D.C., has been closely associated with both the practice of tax law and the study and preparation of tax legislation. Now in private practice, he was for some years United States Solicitor

for Internal Revenue and in that office gained an approach to tax problems which is invaluable in any discussion of them. The title of the article is "Federal Courts as Makers of Income Tax Law", and the gist of his remarks is that the Courts should be chary of extending the application of the law beyond the limits clearly imposed by the words of the statute. Mr. Miller directs his arguments against the tendency of the court either to make difficulties for the would-be tax-avoider, or to attempt to resolve divergencies between the written law and business and accounting ideas.

The reasons which he gives to support a policy of strict interpretation are as follows: In the first place, when the Courts make a new rule in the course of interpreting legislation, that rule unavoidably becomes retroactive to the time when the legislation was passed, a result which can frequently have severe and unfair results. Congress, however, can set a date for the commencement of such changes as it is responsible for, so that a minimum of disturbance will be caused by the amendment. Secondly, it is most difficult to forecast the effect of contemplated business transactions when the Courts consider themselves free to make retroactive changes in the rules which govern the statutes to correct what they consider to be deficiencies in the text of the law. Finally, a tax law is not necessarily intended to run hand in glove with business and accounting ideas or practices, or to give exact justice or retribution to all taxpayers. Its prime purpose is to divert a very large and steady flow of money into the public purse in as simple and direct a way as possible. This is a task which requires techniques and rules which must be closely integrated and which are designed to deal with the great body of taxpayers who will comply with the law, if they can understand it. To do this, the language of the law must be capable of being understood without anxious study of numerous and complicated legal decisions and Congress must sometimes take the calculated risk that some taxpayers will enjoy a benefit which in good conscience they should not have.

Mr. Miller invites his reader to put himself in the position of chairman of a tax committee of Congress and from that vantage point to choose between the contrasting policies of tax legislation. On the one hand there is the policy of drawing a clear, sharp line in the statute between what is taxed and what is not taxed; on the other, to draft relatively vague principles which will not acquire their full or final significance until passed on by the Courts. The clean-cut law will produce the revenue which it is estimated it will produce because of the tax-complying habits of the vast majority of citizens. It will also play into the hands of ingenious tax evaders until such time as Congress deals with them by appropriate amending legislation. The law made up of principles, however, leaves taxpayers in a degree of uncertainty which is unwarranted in tax legislation and at the same time plays into the hands of the bold transgressor who finds its very vagueness to be his protection.

### A Question of Emphasis

The purpose of this article has been no more than to present a few more or less relevant comments on Dean Griswold's approach to the interpretation of tax legislation. One point which becomes apparent in any consideration of the problem is that the difference between the strict and the functional interpretation is one of emphasis and degree rather than a fundamental difference. There are occasions when a Court will have to read something into the statute in order to make it workable. There are other oc-

casions when the statute as it reads is quite workable provided the Court is prepared to approve the consequences. A study of the reported decisions is of interest as a possible indication of a trend in judicial thinking. Dean Griswold indicates that there is a distinct trend in the thinking of the Judges of the Supreme Court in the United States toward the liberal or functional interpretation of the income tax provisions of the Internal Revenue Code. There is reason to believe that a similar trend exists in the Canadian Courts.

To illustrate such trend reference can be made to three cases. The first is that of *Pioneer Laundry & Dry Cleaners Ltd.* v. *Minister of National Revenue,* which came before the Supreme Court of Canada in 1938 and which is reported in [1939] S.C.R. 1.

### The Pioneer Laundry Case

The taxpayer there had resorted to the device of re-incarnating itself so that it might once again be in a position to claim depreciation in respect of assets which had been fully depreciated by a predecessor company of the same name and carrying on the same business. The Minister asserted that his discretionary control over depreciation was wide enough to justify the disallowance of a claim to depreciation which appeared to lack business reality. The Minister was upheld in the Exchequer Court and again in the Supreme Court by a majority of the Judges there. The following quotation from the judgment of Mr. Justice Hudson, who wrote the majority opinion, is most interesting. He said:

> It would seem fairly plain that it was the intention of Parliament that there should be no depreciation allowance unless the Minister in his sole discretion decided that there should be. There is nothing anywhere to indicate the principle or basis on which the depreciation allowance is to be ascertained. It might vary according to different accounting methods, different economic theories, different general business conditions in the country. Nor is there anything in the statute which denies a right in the Minister to look beyond the legal facade for the purpose of ascertaining the realities of ownership or the possibilities of schemes to avoid taxation and it would seem to be that it was the intention of Parliament that the Minister and he alone could properly estimate these different factors.

Dean Griswold would find this approach to a tax Act quite in line with the trend of thinking which he supports. The Privy Council, however, overruled the Supreme Court and set limits to the area within which the Minister could exercise his discretion which were narrower than those which were acceptable to the Supreme Court. The taxpayer's argument had been that a new company had acquired assets in respect of which it had enjoyed no allowance for depreciation. It is a well-known fiction of English common law that a corporation is an entity separate and distinct from those who incorporated it. This fiction was quite as well known to the Supreme Court as to the Privy Council. The disagreement between them was with respect to its application. The Supreme Court regarded it as one of the factors which Parliament intended the Minister to bear in mind in the course of exercising his discretion. The Privy Council held that the discretion only operated on the basis that the fiction was the starting point for the determination of the taxpayer's rights under the statute.

Turning back to Dean Griswold's remarks, it seems incontrovertible that the Supreme Court of Canada when called upon to give practical application to the simple phrase in the statute "such reasonable amount as the Minister may allow for depreciation" felt that "its proper function and duty was to undertake to

construe the language so as to get the proper meaning of Parliament".

### The Security Transfer Tax Case

The next case is that of *Canada China Clay Ltd.* v. *Hepburn, Treasurer of the Province of Ontario* [1945] S.C.R. 87. The appeal there was from a demand by the Province for security transfer tax. The statute imposed a tax upon every change of ownership consequent upon the sale, transfer or assignment of a security made or carried into effect in Ontario. In the circumstances of the case before the Court there had been no actual change of ownership of securities from the appellant company to any other person. Mr. Justice Hudson, again speaking on behalf of the majority, said that there had been a distribution of certain shares on behalf of the appellant company and that this in fact amounted to a change of ownership within the meaning of the statute and the regulations thereunder.

This case is of particular interest because the dissenting minority rested their opinion in favour of the taxpayer upon the very case of *Partington* v. *Attorney General* which is the historical foundation of the rule of strict construction. Once again, the Supreme Court saw fit to adopt a liberal construction of a taxing statute despite the renewed emphasis on strict construction which had been given by the Privy Council a few years earlier in the *Pioneer Laundry* case.

### The Trapp Case Questioned

The third decision is one which has just been rendered by Mr. Justice Graham, the former chairman of the Income Tax Appeal Board, in the case of *Tanner Building Supplies Ltd.* v. *Minister of National Revenue,* 3 T.A.B.C. 218. Mr. Justice Graham there said that it was open to him to assume the purpose which Parliament had in mind when it enacted a particular provision of the *Income War Tax Act,* and then to interpret the legislation so as to give effect to the assumed purpose. In so holding, he took issue with opinions which had been expressed by Mr. Justice Thorson of the Exchequer Court in the well-known decision of *Trapp* v. *Minister of National Revenue* [1946] C.T.C. 30 and followed the lead which had been set by the Supreme Court in such cases as those already referred to by adopting the functional approach to the interpretation of tax legislation. Mr. Justice Graham did this without so much as a passing nod at the decisions of great authority in Great Britain which emphasized the strict construction rule.

A final comment is that there is no judgment of a Canadian Court in which direct consideration has been given to the question of which of the alternative philosophies should be accepted as a guide in interpreting tax legislation. The cases above referred to suggest that there is a trend toward a search for the intention and purpose of the legislation and that arguments of taxpayers resting upon a close and narrow interpretation of the words of the statute will not necessarily prevail. A judge does not rely upon the written words of other judges for mental fare entirely, but is alive to thinking which governs the world around him. Accordingly it is conceivable that many judges, like many ordinary citizens, are no longer quite sure that it is the right and privilege of the taxpayer to defeat a tax claim if he can by resorting to hair-splitting arguments and schemes which fall just within the law. Nevertheless, it may very well be that the old rule that judges should take care not to become law makers should still prevail for reasons such as Mr. Miller has advanced.

# The Quebec Corporation Tax Act

By Wilfrid Turcot, C.A.
*Director of the Quebec Corporation Tax Service*

**A thorough treatment of the subject by its directing head**

THE first Corporation Tax Act was adopted by Quebec in 1882 — and was entitled "an Act to impose certain direct taxes on certain commercial corporations". It provided for the levy of a graduated tax based on the share capital of certain companies and on the number of their places of business in the Province.

### Constitutional Validity

One year later it was contested in court on the ground that it imposed taxation not "within the Province", and was not direct taxation within the meaning of clause 2 of s. 92 of the B.N.A. Act. The Superior Court supported this view and declared that Act *ultra vires* of the Quebec Legislature in 1883. This decision was reversed by the Court of Queen's Bench in 1885 and, finally, in 1887, the Privy Council affirmed the right of the Province to pass such an Act and declared it valid. The judgment of the Court was to the effect that a tax imposed upon companies which carried on business within the Province, varying in amount with the paid-up capital and with the number of its offices, whether or not their principal place of business is within the Province, is direct taxation within clause 2 of s. 92 of the B.N.A. Act, the meaning of which is not restricted in this respect by clause 3 of s. 91.

The latter part of this decision is interesting in that it means in effect that the power of the Province to impose a direct tax is not restricted by the power of the Federal Parliament to do the same and more. In other words, the co-existence of two direct taxes, one levied by the Federal Parliament and another by the Quebec Legislature, was considered possible under the B.N.A. Act as far back as 1887.

### A True Corporation Tax

It is worth noting that the title of the present Act is not the Quebec Capital and Profits Tax Act, but the Quebec Corporation Tax Act. In other words, it is the corporation itself which it is sought to tax rather than its capital and/or profits. The amount of the tax, however, which a corporation is ordered to pay, will depend on its paid-up capital, the number of its offices and its profits, also in certain cases on the percentage of its assets or sales within the Province. There can be no doubt, therefore, that

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this constitutes direct taxation and that the Province is within its right in levying such a tax.

It might be appropriate here to observe that this right of the Province to impose a direct tax cannot be and, in fact, is not affected in any way by reciprocal tax-exemption agreements or conventions between the Government of Canada and the governments of other countries.

### 1. TAX ON PAID-UP CAPITAL

The measure of the tax is threefold: (1) paid-up capital, (2) number of offices, and (3) profits. By "paid-up capital" is meant the capital employed in the enterprise and contributed not only by the shareholders but also by third parties, in the form of loans, mortgages, and advances. As defined in the Act, the term includes:

(a) *The paid-up capital stock of the company, ordinary and preferred,* without any deduction except in the case of mining companies which are permitted to deduct the discount on the capital stock if this item appears clearly on the balance sheet.

(b) *The earned surplus, capital surplus, donated surplus, and all reserves* except the bad debts and depreciation reserves to the extent that these are recognized for profits tax purposes. Any excess of the bad debts and depreciation reserves which was not allowed as a charge against the revenue under the Act must be regarded as part of the surplus and, consequently, included in the paid-up capital. Reserves which, in reality, constitute accurately ascertained liabilities are not, of course, to be included but contingent reserves and investment reserves must be included.

(c) *Bonds, mortgages, debentures, income bonds and income debentures, liens, notes and any security to which the property of the company is subject.* The wording of this clause could justify the inclusion in the paid-up capital of the total amount of bank loans. However, it was agreed to tax only the portion deemed out of the ordinary, to wit, the portion exceeding 25% of the total assets, this proportion being increased to 40% in the case of investment dealers.

(d) *Every other indebtedness of a capital nature.* The application of this clause often gives rise to controversies. I am inclined to believe that a liability may be regarded as being of a capital nature if it remains unpaid for more than 12 months. Often enough the auditor will indicate such long-term liabilities under an appropriate caption in the balance sheet and thus facilitate matters for us, but there are cases where certain liabilities are shown as current in the balance sheet when, in reality, they are, in part at least, of a capital nature. This is particularly true in the case of non-resident-owned subsidiaries which are found to be obviously under-capitalized and abnormally indebted to the parent company. It becomes necessary, in such cases, to determine arbitrarily which part of the indebtedness to the parent company is current and which is not.

### Goodwill

An allowance is made for goodwill to the extent that it is found in excess of its real value, its real value being determined by capitalizing, at the rate of 6%, the net revenue after taxes of the preceding five years or, if the company has been in existence for less than five years, the net revenue after taxes for the period during which the company operated. If it is found that the company has succeeded a previous one engaged in the same type of business, I believe it is but reasonable to have a look at the operating results of the previous company in order to form an opinion as to the value of the goodwill. The word "goodwill" is not restricted to its literal sense. A variety of other terms may be used but if it is found that they can be

assimilated to goodwill, the allowance is granted.

An allowance is also made for investments in other incorporated companies, and in computing this allowance it is necessary to obtain the original cost of the investments since the order-in-council dealing with this allowance stipulates that the cost of the investments must be taken in relation to the *total assets of the company.* This italicized expression means the total assets including the investments at cost after deducting the depreciation and bad debts reserves but after adding back the taxable reserves and any mortgage indebtedness when these items are deducted from the assets.

### Extra-Provincial Corporations

It is necessary to compute the paid-up capital of the entire company in all cases, even those where the company carrying on business in Quebec is a branch of a non-Canadian company or a branch of a Canadian company with head office outside Quebec. Section 4 of the Act provides for relief in such cases and also in the case of local companies which do only part of their business in the Province. This necessitates the passing of an order-in-council annually in each case.

The practice is to recommend that only a proportion of the total tax be levied, based on the ratio of the Quebec assets or that of the Quebec sales, whichever is the greater. Whether this method is sound or unsound is a point on which opinions may be divided but I may say, however, that in the case of local companies which are called upon to pay a capital tax in Ontario, we make sure that the capital tax recommended does not exceed the sum that is obtained by deducting from the tax otherwise exigible an amount equal to half the percentage of Ontario sales. The reason for taking half the percentage of Ontario sales is, of course, because the rate of the capital tax in Ontario is half that of Quebec. It was not found feasible in all cases to deduct the actual amount of the Ontario capital tax for the reason that Ontario has a slightly different method of computing the paid-up capital. Furthermore, it is desired to avoid duplication of provincial taxation on the same capital. There are also cases where extra-provincial companies may have the bulk of their assets in this Province although their sales to Quebec customers may represent but a small fraction of their total volume of sales. It is considered fair in such cases to base the capital tax on the proportion of the assets in this Province.

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### Location of Head Office

This leads me to say a few words about the definition of the term "head office" in the Act. It is often found that a company may have been incorporated in another Province but that its entire industrial and commercial activities are carried on in Quebec. In other words, what is designated as the head office is, in reality, only a nominal one. In such cases, the Minister has the power under the Act to issue a decree to the effect that for all purposes of the *Quebec Corporation Tax Act,* the company shall be deemed to have its head office in Quebec. The effect of this decree is that an extra-provincial company may be treated exactly as a local company and be called upon to pay the capital and profits taxes in full. Conversely, if a

company though having its head office in Quebec conducts all its activities elsewhere, consideration is given to this fact and a special recommendation is made to the Council varying with the merits of each case.

### Other Bases

Other methods may be recommended as a basis for establishing the capital tax. For instance, in the case of companies engaged in the business of transportation by land, air, or water, we may recommend the revenue-mileage basis or the tonnage-call formula, as the case may be.

### Branches of Partnerships, etc.

Partnerships and private enterprises are not taxed under the Act except those which have their chief office or principal place of business outside Canada and are found to be transacting business in this Province through a branch office or a resident agent. In such cases, the capital tax is 1/10 of 1% on the gross revenues in the Province with a minimum of $25.

The definition of the word "company" also includes a trustee, assignee, liquidator, or other person in whose hands the affairs of a company may have been placed temporarily.

### Insurers, Banks, etc.

Insurance companies are asked to pay 2% on every premium received in respect of their *business transacted in Quebec*. This italicized expression means contracts of insurance on a person residing in Quebec or on property situated in Quebec, if such person is a resident of Quebec at the time of payment of the premium or if such property has a situs within Quebec at any time during the terms of insurance.

Banks are called upon to pay a greater capital tax than ordinary companies to compensate for the fact that they are not subject to the profits tax.

There are clauses in the Act providing a special rate of capital tax in the case of loan, telegraph, express, telephone, tramway, railway, trust, car, gasoline, real estate, brewery and tobacco companies.

There are also special orders-in-council for holding companies and for mining companies which have not reached the production stage.

### Non-Resident Transportation Companies

In the case of non-resident navigation companies, it may be appropriate to mention here that if they operate a regular service between points in this Province and other countries, and if they have a resident agent in this Province and solicit business locally through any type of advertising, they are deemed to be carrying on business in this Province and must file annual returns the same as any ordinary company. To these returns must be attached the financial statements of the company as a whole, since no separate accounting is permissible under the Act, but the capital and profit taxes will only be exigible in the proportion that their Quebec business bears to their total business everywhere. Such proportion is to be determined according to the tonnage-call formula or any other basis which may be found mutually satisfactory and equitable.

### "Doing Business"

The definition of the expression "doing business" in the *Quebec Corporation Tax Act* goes much further than the meaning of the expression in the Dominion *Income Tax Act*, with the result that a non-resident company may be deemed to be taxable under the Quebec Act and not so under the Dominion statute. The mere fact of having a resident representative in the Province renders a company subject to the provisions of the Quebec Act.

### Personal Corporations

There are no provisions in the Act exempting personal corporations as such. If these companies can be regarded as holding companies within the meaning of the Act, i.e. if their assets consist only of stocks, bonds, and other securities of incorporated companies, they are subject to the special tariff applicable to holding companies, but if their assets consist of or include revenue-producing real estate properties they are treated as ordinary companies.

### Defunct Corporations

It is also to be observed that companies which have ceased operations and may be without assets are, nevertheless, required to pay a $20 annual fee, if they have not surrendered their charter or until such time as their charter may be deemed forfeited through non-user.

## 2. PLACE OF BUSINESS TAX

The place of business tax is not exigible in the case of insurance companies, telegraph, telephone and express companies, tramway and railway companies, but is exigible in full in all other cases. Non-resident companies carrying on business through a resident agent who may operate from his domicile are, nevertheless, deemed to have a place of business.

## 3. TAX ON PROFITS

The profits tax is applicable to all companies except banks and insurance companies, tramway, railway and trust companies.

### Resident Companies

In the case of local companies, the tax is computed on the entire profits but by virtue of s. 9 there may be deducted the lesser of the amount of the tax actually paid to another province or 7% on that part of the profits deemed earned outside the Province. The interpretation given to this section of the Act is to the effect that the total of the provincial taxes paid may be matched with the total Quebec tax which would otherwise have been paid on such profits earned outside the Province of Quebec. In other words, the comparison is not to be made for each Province but the grand totals for all Provinces may be matched. This affords a certain relief in the event a company is asked to pay to another Province a little more than would ordinarily be expected owing to the disparity at present existing in the methods of apportionment.

### Deduction for Foreign Taxes

Foreign taxes may be claimed if they can be assimilated to provincial taxes, i.e., if they are paid not to the central government of a foreign country but to the government of a political subdivision of a foreign country. Foreign taxes paid to the central government of a foreign country are, as a rule, deductible from Dominion income tax, and for this reason are deemed to be reimbursed to the extent of the tax credit allowed by the Dominion. However, if the amount of foreign taxes paid exceed the tax credit allowed under the Dominion *Income Tax Act* the excess may be claimed to the extent of our rate of tax.

### Sales of Resident Company

Under s. 31, a company having its head office in Quebec must consider all its sales as having been made in Quebec, unless it pays a profits tax to another Province or country. According to the wording of the Act, it is the residence of the customer that determines to which Province the sale must be attributed. However, in view of the fact that other Provinces may sometimes allocate sales in a different manner, and in order to avoid the resultant duplication of provincial taxation, it was agreed to broaden the interpretation to be given to

the provisions of s. 31. For example, when another Province considers that all the goods manufactured within its boundaries are to be treated as sales in that Province, whether these goods be sold to residents of that Province or to residents of another Province in which the company is not subject to a profits tax, Quebec will allocate these sales to the Province where the goods are manufactured, exception being made, however, for any part of such goods which may be sold to customers residing in Quebec, in which latter case the sale must be deemed to be made in Quebec.

### Foreign Companies With Quebec Head Office

A non-Canadian company whose principal establishment for its business transacted in Canada is in Quebec, is treated as a company with head office in Quebec except that the export sales, if any, made by such Canadian branch are not deemed to be made in Quebec.

### Extra-Provincial Companies

A Canadian company having its head office in another Province of Canada but deemed to be carrying on business in Quebec is only taxed on its profits to the extent of the proportion which its sales to Quebec residents or its gross income derived from Quebec sources bear to its total sales or total gross income.

### Export Sales

Export sales made by a Canadian company and involving no tax in the country of their destination are usually attributable to the Province where the head office of the selling company is located. However, there may be isolated cases where a Canadian company, because it has several factories located at various points in Canada, any of which may be called upon to execute orders for delivery outside Canada, may for this reason be required by another Province to allocate export sales according to the place where such orders are executed. Such cases may, upon presentation of all the facts, be accorded special consideration.

### Reciprocal Agreement with Ontario

Also, by virtue of a reciprocal agreement with the Province of Ontario, sales made or services rendered by a company to the Government of Canada, a Crown company, or a company or organization controlled by the Government of Canada, are to be attributed to the Province where the goods were manufactured or the services performed by the company, irrespective of the location of its head office.

### Apportionment of Profits

The allocation of sales, once made, serves as a means to apportion the income of the company. The question of the salaries or wages paid should not enter the picture. The method of averaging sales and wages ratios, which, I understand, was first inaugurated by Massachusetts, is not recognized for Quebec tax purposes. Certain American States, I believe, take a third factor into account viz., the assets ratio, so that their method is a combination of three ratios.

In secs. 9 and 30 of the *Quebec Corporation Tax Act* the sales ratio is clearly indicated as a method of apportionment. It is a simpler method evidently based on the principle that the Province which furnishes the customer should be given preference over that which provides the labor. Such a principle would not appear inequitable towards the less industrialized Provinces. It might indeed prove to be to their advantage if a comparison could be made.

In any event, there is no denying that the different methods in use for the apportionment of income necessarily bring about a certain duplication of provincial

taxation and, although fortunately there are not many such cases, it would undoubtedly be most desirable to have a uniform rule throughout Canada on this point. Our neighbours to the south, however, do not seem to worry too much about the same problem although they are far from having uniformity on the question.

### Exceptions to Sales Ratio

An exception to the rule of using the sales ratio for the apportionment of the income is made in the case of real estate companies, companies owning and operating grain elevators and companies whose operations tend to deplete the natural resources of the Province. In such cases, the income is apportioned according to the ratio of the fixed assets and inventories situated within and outside Quebec.

As regards shipping companies, the income may be allocated according to the tonnage-call formula, such as is described in the Ontario *Corporations Tax Act*. For other transportation companies, the revenue-mileage basis may be used.

### Investment Income

The income subject to apportionment must include the income derived from investments, except dividends which are not taxed under our Act. The taxing of a proportion of the investment income, in the case of Ontario companies having a place of business in Quebec, creates a duplication of provincial taxation, since Ontario considers the investment income of such companies not subject to allocation and, consequently, taxes the whole of it. There is no way of avoiding this duplication of tax so long as the Act remains as it is.

### Computation of Profits

In the computation of the net profits, the deductions allowable are pretty nearly the same as for the purposes of the Dominion *Income Tax Act*. We follow the jurisprudence existing on income tax in general. There is one important exception, however, viz., depreciation.

### Depreciation

Until notice to the contrary, the depreciation to be claimed for the year 1950 and any fiscal year ending therein should not exceed the total amount that may be obtained by applying the rates and method used by the company in the years 1947 and 1948. Any excess will be disallowed. This, I know, creates many complications but it is a situation that has to be faced. I realize that this will necessitate the preparation of a separate set of depreciation schedules along the same lines as 1948 and previous years. I had hoped this might be avoided, but there seem to be no alternative if one is interested in recapturing at some later date the excess depreciation disallowed.

There is also the question of capital profits and losses on disposals which must continue to be disregarded for the purpose of determining the taxable income. Moreover, if a company which was disallowed a certain amount of depreciation, say in 1949, finds that in 1950 or a subsequent year it would be entitled to more depreciation under the old system than under the new, it may claim the greater amount, to the extent that this will not bring the reserve, for Quebec tax purposes, in excess of that appearing in the books. Hence the necessity of keeping separate schedules.

Pending the issue of a list of rates, new companies are asked to use the rates generally recognized in 1948 and prior years.

### No Loss Carry-Over

At present there are no provisions permitting a company to deduct the loss of one year from the profits of another. However, if by reason of such a clause

existing in the other provincial Acts, a company is partly or totally exempted from the payment of the 5% tax otherwise exigible on the income earned in other provinces, a deduction from the Quebec tax will be allowed not exceeding the full amount of the 5% tax which would otherwise have been paid.

Although the Act does not provide any procedure for lodging appeals, any company which objects to the amount at which it is assessed can be assured of being given ample opportunity to present its case. As may well be understood, legal action is only recommended after consideration of all the facts and if it becomes apparent that no equitable settlement can be reached.

## A Recent Book

**Consolidated and Other Group Accounts, by T. B. Robson; published by Gee & Co. (Publishers) Ltd., London; pp. 143 and index; price 17/6**

This is the second edition of a book which was originally published in 1946 and the revision has been made to incorporate changes required under the British *Companies Act, 1948*. The book represents an excellent source of reference to problems arising in the preparation of consolidated statements, and accountants will find the explanations of principles involved in consolidations of particular value.

The terminology includes a number of references which may sound unusual to Canadians, e.g. references to "capital reserves" and "revenue reserves", and there is a considerable amount of material which deals with problems of British income tax and problems arising under particular provisions of the British *Companies Act*. While some of this material will be of value to Canadian accountants only on rare occasions, it does not detract from the usefulness of the material ordinarily applicable in Canada.

The book contains an appendix of 38 pages setting out in detail an example of a consolidation with all the working sheets and necessary journal entries, which should be of particular value to a student or to an accountant dealing with consolidations, as it deals with practically all the problems generally encountered.

One matter of particular interest, dealt with in some detail, is the determination of the amount of earnings up to the date of acquisition of shares in a subsidiary where the shares are acquired over a number of years. Another is the valuation to be placed on fixed assets in the consolidated statements, where, in arriving at the price paid for shares of a subsidiary, a value for the fixed assets has been used which is materially in excess of the depreciated value of the fixed assets as carried in the books of the subsidiary.

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# Pointers on the Technique Of Writing Audit Comments

By Jennie M. Palen, C.P.A.

**The auditor's main concern is with auditing, but he must learn to write superlatively well**

TO write really good comments in an audit report is a peculiarly difficult and frustrating task; difficult because involved technical matters must be expressed in language understandable by persons without comparable technical training; frustrating because the auditor's major concern is with auditing, not writing; frustrating, also, because his need for exactness is so great that his writing must be heavily censored.

### A Mental Hazard

This situation is not conducive to confidence in one's writing ability. Yet the accountant, who must always think clearly and has a flair for taking pains, should write superlatively well. Some accountants have made a mental hazard of writing, believing there is some antagonism between it and accounting. If this were true, the great body of our splendid accounting literature would never have been written.

We all learned early in life the rudiments of grammar — or where to find them. We learned how to spell — or where to look for correct spellings. With these preliminaries, one or two good reference books, and an unabridged dictionary, the accountant is as well equipped as he needs be to write *correctly*. With practice and love of his task, style and effectiveness, too, may be his.

### Interest

Because, in an audit report, we are writing about our client's innermost financial affairs, what we write should, theoretically, interest him. We cannot hold his interest, however, if we talk all around the subject, load our comments with trite, abstract, and meaningless words, and in general act as if we are bored with the whole thing. And we are not bored really. We have reached a point in our work where we have a great many important things to say and we are bursting to say them, but we are bothered by the mechanics of putting them down on paper.

This problem is especially acute in the long-form report where the comments are lengthy and where verifications are described and breakdowns given under the heading of various asset, liability, and operating accounts.

To recast a certain number of sentences so that *we* will not be the first word in thirty per cent of them; to find interesting variants for the ubiquitous

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*this item, this amount consists of the following,* etc.; in short, to make the comments sound as if they had been written out of the warmth of our own thinking, and not from last year's copy, is one of the toughest jobs in report writing.

The crystallization of the idea that a certificate should always be given where possible has offered one solution to this problem by making it unnecessary to describe all the audit procedures unless it is desired to do so. Even where the audit procedures are described in detail it is feasible sometimes to group their description in one long paragraph and to place the more interesting comments where they will receive better attention, either under individual asset or liability headings or under such other headings as may be appropriate.

### Using the Exhibits

Total wordage may frequently be reduced by expressing pertinent facts in the exhibits. If, for instance, one item in trade accounts receivable is so large that it is desirable to name the debtor, the accounts may be shown in the balance sheet thus:

| | | |
|---|---|---|
| Trade accounts receivable: | | |
| John Jones Co. | $95,000 | |
| Other | 5,000 | $100,000 |

Sometimes all information may be included in the balance sheet description. Here is a sample found under liabilities:

> "Unpaid portion of 1947 Federal income tax of predecessor companv. awaiting adjustment of claim for abatement."

Of course, the balance sheet should not be cluttered with useless detail, but usually both financial statements and comments are improved by compressing needed information into condensed form.

Except possibly for certain phrases which are so exact that there is no usable substitute for them, the wording of comments cannot be reduced to formula. To do so would be to defeat their real purpose, which is to call attention to significant matters and new developments. Certain expressions have proved their worth, such as, "cash on hand was counted and that on deposit was verified by certifications obtained from depositaries", "funds held by agents were acknowledged by them", "notes receivable and the collateral shown to be held thereunder were confirmed by the makers", etc. But even these are not uniform throughout the profession. There are, however, typical accounting situations and typical pitfalls in reporting them. Knowledge of accounting and a basic knowledge of the principles governing grammatical construction and the use of words will solve them.

### The Five "C's"

George Burton Hotchkiss has defined the five "C's" of business English as, in the order of their importance, clearness, correctness, conciseness, courtesy, and character. But for accountants the list should include another "C", and that is caution.

An audit report is a signed, written record, a permanent document, and a serious matter. Money is lent or permanently invested on the basis of its showing. Sometimes people are sued because of it and sometimes those people are the auditors. Not only in the financial statements but in the wording of the comments care is needed to insure that nothing is said that cannot be supported in court. Where defalcations are reported the problem is especially difficult. No unnecessary personal references should be made and the words should express only such evidence as the books support. Dates, names, and book entries, where quoted, should be quoted exactly, including even any er-

roneous spellings, and photostat copies of cancelled cheques and other records are frequently made a part of the report. Usually a defalcation report consists only of comments, unless there are numerous irregularities of a similar nature, so that exhibits and schedules may be used to advantage. The comments may effectively present a summary, then details, then a description of the manner in which the defalcation was brought about. A sample report reads as follows:

We have made an examination of certain of your records for the period from May 1, 1949, to March 26, 1950, for the purpose of establishing the extent of irregularities disclosed during the course of our examination for the year ended January 31, 1950.

Total irregularities amounting to $8,540 were found, as follows:

| | |
|---|---|
| Collections on accounts receivable not accounted for | $5,230 |
| Checks drawn to J. Smith and charged to expense, not supported by vouchers or other receipts | 3,310 |
| Total | $8,540 |

The collections on accounts receivable not accounted for are as follows:

.....

.....

It appears that the method used to conceal these irregularities was to make a credit entry in the customer's account for the amount of the collection, but to make no corresponding entry in the cash book at the time of receipt, inserting these amounts in the cash book after it had been footed by an assistant. Trial balances were submitted each month but were overfooted to agree with the controlling account.

In the hope that it will afford practical assistance, discussion of Mr. Hotchkiss' five "C's" will be based entirely on examples of violations lifted from rought drafts of reports and from published or typed reports of many accounting firms. None of these has been manufactured to serve as a horrible example. Most of the reports from which they were taken were written by accountants of senior or higher grade and they may therefore be regarded as fair samples of the points which give the most trouble.

Courtesy and character, being easily defined, will be covered first.

## Courtesy

Courtesy implies the use of tact in expressing that which may offend. As accountants we must, unfortunately, criticize — and in practice it is found that the mildest criticism can release untold furies. Of course, important truths may never be withheld just because they may be unpalatable to the client, but they may be stated in as inoffensive a manner as is consistent with truthfulness. Words and phrases with unpleasant connotations such as *errors, mistakes, wasted time, shortage, carelessness, inefficiency, refusal,* etc., can become fighting words, not to say dangerous ones, and it is well to learn early in life harmless yet effective substitutes to use on occasion.

Criticisms are more welcome when they dwell on the cure rather than on the crime. For instance, instead of saying, "Too many accounts are carried in one ledger and, as a result, a great deal of time is wasted in looking for errors at the end of the month", we may say, "Much of the checking incident to balancing could be avoided if the accounts were divided into several sections with a controlling account for each section."

### Character

The character desired in a report (other than that imparted by the very important factor of technical accounting knowledge) is obtained by the use of a dignified, impersonal tone. Dignity, however, is not enhanced by suffocating our ideas in yards of such cotton-wool expressions as "in the case of", "with respect to", "of this character", "of this nature", etc. It is occasionally convenient to use these expressions but tone and vigor are greatly improved by recasting sentences to avoid their constant use. Neither is dignity enhanced by such phrases as "not without interest", "venture to state", "wish to inform", etc. "We wish to inform" and "we would suggest" are apparently occupational hazards of the business writer. Why wish to do something which we are already doing? Let's use simply "we suggest" or "it is suggested". or better still, no introductory phrase at all. We may say, for instance, "Monthly summaries of sales, by products, would give an up-to-the-minute picture of consumer buying", rather than "We should like to suggest the preparation of monthly statements showing the nature of the sales as to type of product for the use of officials in appraising the character and volume of customers' requirements". Here are 35 words where 17 do a better job, and even the 17 may be reduced to 14 by using *current* for *up-to-the-minute*.

Archaic or flippant expressions, foreign words, slang, figures of speech, the half sentence have small utility in the audit report. To be good, writing should be appropriate. To be offhand in an audit report is not only inappropriate, it may be downright foolhardy. If anything in an audit report is vague, inaccurate, or subject to more than one interpretation, if it contains non-dictionary words which cannot be defined, serious trouble may result.

Clearness, correctness, and conciseness, the remaining three qualities, are so important that every sentence in the report should be tested for their presence.

### Clearness

Clearness means not only that each statement can be understood but that it cannot reasonably be misunderstood. Correctness relates to both subject matter and the manner in which it is expressed. The facts must be exactly as stated; the construction must conform to the rules of grammar; and the words must be used in their exact sense. Conciseness requires that every thought be expressed in as few words as is consistent with smoothness and completeness. Conciseness is not to be confused with brevity. Many people, in their desire to be brief, leave out important facts or omit words necessary to the construction. Conciseness never requires the omission of things of value, but does require omission of the valueless or relatively unimportant.

The best aid to clarity is good sentence structure. Strong, direct sentences in which the ideas are logically arranged make for clearness. The principal idea in the sentence should occupy the principal clause. Important sentences and first sentences of paragraphs should not have weak beginnings.

If one of the ideas is subordinate to the other they should be joined by connectives which will express the proper relationship. Note the weakness of this sentence: "Only a few entries of deposits made or checks drawn appear on the stubs, but the bank account is active." Then see how the proper connective improves it: "Although the bank account is active, only a few entries of deposits made and checks drawn appear on the stubs."

Changing the viewpoint within the

sentence weakens its effect. When we say, "The entries in the property account were examined and appear to be proper", the thought runs smoothly through the sentence; but if we say, "We examined the entries in the property accounts and they appear to be proper", the thought is slowed by shifting attention from *we* to *they*.

Parallel ideas in a sentence should be put, as a rule, in parallel construction. The phrase, "due to carelessness on the part of clerks and because supervision is lacking", is weak and shambling, whereas "due to carelessness on the part of clerks and to lack of supervision" is effective.

### Avoid Long Sentences

On the other hand, confusion is assured when long sentences continue until their beginning is forgotten, when clause is tacked on to clause and modifier on to modifier. Here is such a sentence:

> We have reconciled the accounts with the various correspondent banks, and in this connection, during the course of examination while endeavouring to effect a reconciliation with correspondent banks, our representative, working in conjunction with Mr. Jones of the bank's accounting department, developed the fact that the chief teller of the commercial department had taken credit for amounts which should have been credited to the X Bank of New York.

All the writer needs to say here is:

> Reconciliation of the accounts with correspondent banks disclosed the fact that certain amounts which should have been credited to the X Bank of New York were, instead credited to the account of the chief teller of the commercial department.

Confusion also arises through poor placing of modifiers. Each modifier should be so placed that the reader sees unmistakably to what word or group of words it refers. *Only* is a word frequently misplaced. "Expenses only include one-half the sales manager's salary." Since *only* relates to *one-half* and not to *include*, the sentence should read: "Expenses include only one-half the sales manager's salary."

When we write that "these charges are regarded as collectible by the treasurer", the reader is justified in inferring that only the treasurer can collect them. With correct placing of the modifier the sentence reads, "These charges are regarded by the treasurer as collectible." Please note, too, the ambiguity that results if the reference to the treasurer is omitted. The inference then is that the accountant regards the charges as collectible. The same care should be applied in using the word *estimated*. The responsibility for the estimate, as well as its basis, should be established.

The use of specific rather than general terms is an aid to clearness. *Real estate*, for instance, is an ambiguous term because it may mean land, buildings, or both.

Clearness is hindered by a poor arrangement of ideas, as in this sentence:

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**She is the author of numerous articles on accounting, English, and related subjects, and her poetry has been widely published.**

> During the period depreciation was charged to operations at the following rates for nine months . . . .

It is not clear here whether the rates were for nine months or whether they were yearly rates of which a nine months' proportion was taken. The sentence would be clear if it read as follows:

> During the nine months under review depreciation was charged to operations at the following annual rates . . . .

A little care in thinking will warn us not to speak of the book value of an asset account, but of the book value (or carrying value) of the asset. It is not the accounts receivable which are in agreement with the controlling account; it is the total of the individual balances which is in agreement with the controlling account. A company does not "transfer assets *contained* in schedule 1"; it "transfers assets *listed* in schedule 1". Neither does it "charge off the balance of live stock account disposed of", since, undoubtedly, it was the live stock that was disposed of, not the account.

### Correctness

Next in importance to clearness is grammatical correctness.

Experience shows that certain types of grammatical error appear over and over.

Tense is a major stumbling block. The past tense is the tense of narration. We usually use it in telling what we did. When we write the certificate we are giving a current opinion based on work completed. So we use the present perfect tense to describe the work ("We *have examined* . . . ") and the present tense in certifying ("in our opinion the accompanying . . . *present* fairly . . ."). Similarly, in a presentation we say, "We *have made* an examination . . . and *submit* . . . ," the act of submittal being assumed to take place on the day the report is dated.

When it is necessary to refer to action completed prior to the time indicated by the principal verb, usually the past perfect is used with the past tense and the present perfect with the present tense; as, "Reconciliation of the bank account *disclosed* that it *had* not *been reconciled* since March 31, 1950"; and "We *understand* that the new company *has agreed* to take over these assets at book value"; but "We *understand* that, prior to negotiations with the bankers, the new company *had agreed*, etc. . . . " There are, however, a great number of combinations of tenses and we have to use our judgment to determine which combinations best express the relationships.

Truths that continue into the present should be expressed in the present tense. "We were informed by the treasurer that the payrolls *are disbursed* by the foremen each Friday morning."

A verb should agree in number with its subject noun, not with an intervening modifier. Thus we say, "the total of accounts receivable differs . . . ." *Differs* agrees with its singular subject *total*, not with *accounts*.

A similar subject, although followed by a parenthetical phrase, takes a singular verb. In the sentence, "The amount of this note, together with the pledge as collateral thereto of 15 shares of *A Co.* stock, were confirmed by the bank", *were* is incorrectly used because the subject is *amount* and the phrase *together with the pledge, etc.* is a modifying phrase, not another subject. The sentence should read, "The amount of this note, together with the pledge as collateral . . . was confirmed . . . " Words joined to the subject by such expressions as *in addition to, as well as, with,* or *together with* are parenthetical and do not constitute another subject.

Two or more singular nouns joined by *or* or *nor* take a singular verb, and

two or more subjects of a different number joined by *or* or *nor* take a verb of the number of the nearest subject. Thus we should say, "Neither the sales records nor the cash book contains a record of this transaction."

Principal verbs should not be supplied from one part of the sentence to another if the same form is not grammatically correct in both parts. Observe how this principle is here violated: "$2,000 has been paid in cash on this subscription and twenty shares of stock issued therefor." If we try to supply from the first clause the part of the verb that is missing from the second clause we have this result: "twenty shares of stock has been issued", which is, of course, wrong. The sentence should read: "Two thousand dollars has been paid in cash on this subscription, and twenty shares of stock have been issued therefor."

The foregoing sentence is also an illustration of the rule that *dollars,* when it refers to a sum of money, takes a singular verb.

A common error is that of using a participle to introduce a sentence when it does not logically modify the subject of the sentence. "Based upon our review of the accounts with the credit manager, all appear to be collectible." "Having reviewed the accounts with the credit manager, all appear to be collectible." Each of these sentences has a dangling modifier — a modifier with nothing to modify. They should be revised to read: "Based upon our review . . . our opinion is that the accounts are collectible"; "upon the basis of our review . . . all appear to be collectible"; "having reviewed . . . we believe that all are collectible"; or (preferably) "the accounts were reviewed with the credit manager and appear to be collectible."

Almost as common is the error of comparing two things without naming the second. "The method of control used is better than all methods in use" should of course read, " . . . than all *other* methods in use". And the sentence which read, "There is a difference of $100 between the bank balance as shown by the company and the bank" should have read, " . . . between the balance as shown by the company and that shown by the bank".

### The Comma

The placing of commas gives rise to many questions. In general, marks of punctuation should be used where they will facilitate reading and where they will maintain proper sentence and thought values. The comma, since it represents the shortest pause, is especially flexible in its use. It may always be used where it will aid clarity. One comma rule that is inflexible, however, is that a relative noun clause which is restrictive in meaning should not be set off by commas. If we say, for instance, "The factory expenses were distributed on the basis of the cost of materials *which were used in manufacture",* we here have a restrictive clause and need no comma after *materials.* A comma placed there would imply that the distribution was on the basis of the cost of *all* materials, and that all materials were consumed.

A large proportion of the errors in reports arises from the incorrect use of words.

Confusion apparently exists as to the proper use of *quantity, amount,* and *number.* A moment's thought will indicate which word applies. In the sentence, "A large amount of lumber is stored under the sheds and not controlled", it is obvious that the proper word is *quantity* and not *amount.* On the other hand, in this sentence, "The contract calls for the sale of stock in

quantity up to $1,000,000", it would clearly be better to say, "to a total amount of $1,000,000". And instead of saying, "A considerable amount of changes will be required", we should certainly say, "A considerable number of changes . . . "

An accountant should also remember that assets are *collected* and that liabilities are *paid;* expenses are *incurred,* income *realized;* and that we speak of *realization* of assets, *liquidation* of liabilities.

It is poor usage to employ *same* as a pronoun ("We checked the charges and found *same* to be correct"); *said* as a participial adjective ("The securities are held by X Bank as collateral and were confirmed by *said* bank"); or *party* for *person.*

*Advise* is employed to excess in the sense of *inform.* Many people say *advise* on every possible occasion and the word has become hackneyed in the extreme.

*Former* and *latter* should not be used to designate one of more than two persons or things. To designate one of three or more say *first* or *first-named,* and *last* or *last-named.* In the sentence, "The operations were conducted during only the latter nine months of the year", *latter* should be *last,* because we are speaking of nine of twelve months.

*Verbal* is often improperly used for *oral. Verbal* means *expressed in words. Oral* means *spoken.* Thus we should say, "The amount of this liability was confirmed to us *orally* by the creditor", not "confirmed to us *verbally* . . . "

The word *confirm* is a source of trouble. In the accountant's lexicon, confirmation is corroborative evidence obtained from another. It is technically inexact to say that "we *confirmed* customers' accounts". It is better to say that "requests for confirmation of the balances shown in their accounts were mailed to customers". Sometimes an auditor even errs so badly as to say that "*confirmations* were mailed to customers", confusing the *form* used in asking corroboration with the confirmation itself.

Care should be taken that assets (or liabilities) are not spoken of as *secured* when they are in fact only partially secured. Where, for instance, securities having a value, based on market quotations, of $8,000 are held as collateral under a $10,000 note receivable, it is a misstatement to say that the note is "*secured* by 100 shares *X Co.* capital stock". In such a case we can say no more than that the note is "*partially* secured by pledge of 100 shares *X Co.* capital stock, having a value of $8,000 based on market quotations at December 31, 1949". Or, if the market value is not determinable, we may say that "One hundred shares *X Co.* capital stock are held as collateral to this note. We were unable to determine the market value of the stock." (*One hundred* is spelled out here because it is at the beginning of the sentence.)

### Prepositions

The correct use of prepositions requires some care. An unabridged dictionary usually indicates the prepositions to be used after words in specific meanings.

It is correct to say "subscriptions *for* capital stock", "subscriptions *for* periodicals", but "subscriptions *to* a fund".

*Between* is used in speaking of two things; *among,* when speaking of more than two; as, "A varying percentage of the profits is divided among the heads of departments"; "the responsibility for the petty cash is now divided between the cashier and the bookkeeper."

After *site, of* is used where the object is already located on the site. *For* is used when the object is spoken of as

not yet being there. Thus we say, "the site *of* the factory", but "land purchased as a site *for* an office building".

After *security, for* is used; after *collateral, to* or *under.*

After *purchase, of* and *from* are used as follows: "The purchase *of* land *from* the Midtown Realty Company was authorized by the board of directors"; or, "The land was purchased *from* (not *of*) the Midtown Realty Company."

### Conciseness

That brings us to conciseness, or the art of making one word do the work of two. Conciseness has been touched upon at several points in connection with other matters. Clear thinking and conciseness go hand in hand.

There is no need to say that "the reserve for doubtful accounts appears to be ample to provide for losses in the collection of the accounts receivable". All that is necessary is to say that "the reserve for doubtful accounts appears to be ample." If we reviewed the accounts with the credit manager we do not need to say that "in his opinion they are considered collectible", but only that "in his opinion they are collectible".

Such expressions as *cost price* and *cost value* may be reduced to the one word *cost.* The word *remains* means *is still* and we do not need to say *still remains.* Nor does the word *actual* add anything to the meaning in the phrase "by *actual* count". If we have completed an operation we do not need to say that it is *fully* completed.

There is a great deal of uncalled-for repetition of words in tabulations. Under *reserves*, it is not necessary to repeat the word *for* before each item. Also we may usually eliminate, in the description of the items, words which are contained in the heading, as in the following:

Subscription accounts:
Unpaid capital stock subscriptions
Unpaid building fund subscriptions.

Such a tabulation might better read:

Subscription accounts:
Capital stock
Building fund.

## FESTIVAL OF BRITAIN
## SPECIAL WELCOME FOR ACCOUNTANTS

The editor of *The Accountant*, the well-known English accounting publication, extends a cordial invitation to accountants from overseas, who will be visiting England for the Festival of Britain, to call on him at the editorial offices, 4 Drapers' Gardens, Throgmorton Avenue, London. He would be delighted to meet visitors and to have an opportunity of discussing matters of interest to the profession.

# Obituaries

### Henry G. L. Bennett

The Institute of Chartered Accountants of Ontario announces with regret the death of Henry Granville L. Bennett, C.A. at his home in Toronto on March 17, 1951 in his 55th year. For many years he had been a partner with the firm of Wilton C. Eddis & Sons, Chartered Accountants, and had served on the Taxation Committee of the Institute. He was the author of the new edition of "Your Income Tax". Lifelong resident of Toronto, he served in the First World War as a lieutenant in the Canadian Army.

To his wife and the members of his family the Institute extends sincere sympathy.

### John Bertram McNair

The Institute of Chartered Accountants of Manitoba announces with deep regret the death of John Bertram McNair aboard a Southern Pacific train near Phoenix, Ariz.

Mr. McNair was widely known in financial circles and in the grain trade as treasurer, since 1930, of the United Grain Growers Limited, with which company he had been associated for 38 years.

Born and educated in London, Ontario, he came West as a young man and received training as an accountant with John Scott & Company. In 1913 he became Accountant with the Grain Growers Grain Company, now United Grain Growers Limited.

A keen golfer, Mr. McNair had been a member of the old Norwood Golf Club and until recently, when his health prevented further playing, a member of the Pine Ridge Golf Club. He was also a member of the Manitoba Club.

To his widow and family the members of the Institute extend their deepest sympathy.

### Robert L. Ahara

The President and Council of The Institute of Chartered Accountants of Ontario announce with regret the very sudden death of Robert L. Ahara of Ottawa on March 18, 1951. Mr. Ahara graduated from Victoria College, University of Toronto in 1928 in Commerce and Finance. He became a chartered accountant in 1935 and was for some years an auditor with the Government of Canada in both Toronto and Ottawa. To his wife and members of his family the Institute extends sincere sympathy.

# Professional Notes

## ALBERTA

### Calgary Chartered Accountants Club

The regular monthly luncheon meeting of the Calgary Chartered Accountants Club was held in the Palliser Hotel on Friday, March 16, 1951. Mr. K. J. Morrison, O.B.E., F.C.A., president of the Canadian Institute of Chartered Accountants, gave an outline of pending provincial legislation which is of interest to the members and a general discussion followed. Mr. H. H. Love, C.A., vice-president of the club, presided.

Mr. George Peters of Westcoast Transmission Co. was the guest speaker at the April luncheon of the Calgary Chartered Accountants Club held in the Palliser Hotel on April 6. Mr. Peters spoke on "Export Pipelines for Natural Gas" and outlined the various proposed routes and the locations of known gas fields and likely markets. Mr. J. G. Simonton, C.A. presided at the meeting which was attended by more than 50 members.

BRITISH COLUMBIA

Messrs. W. G. Rowe, F.C.A. and G. W. Carlisle, C.A. announce the formation of a partnership for the practice of their profession under the firm name of W. G. Rowe & Co., Chartered Accountants, with offices at 522 Standard Bldg., 510 W. Hastings St., Vancouver.

* * *

Mr. P. A. Gibbs, C.A. announces the admission to partnership of Mr. R. L. V. Jermain, C.A. Henceforth practice of their profession will be carried on under the firm name of P. A. Gibbs & Co., Chartered Accountants, with offices at 403 Royal Trust Bldg., 612 View St., Victoria.

* * *

Mr. W. Russell Watson, C.A. announces the admission to partnership of Mr. John B. Ewing, C.A. Practice of the profession will be continued under the firm name of W. Russell Watson & Co., Chartered Accountants, with offices at Rms. 401-3, 602 W. Hastings St., Vancouver.

* * *

R. E. Sayce & Co., Chartered Accountants, 736 Granville St., Vancouver, announce the admission to partnership of Mr. Ernest Burnett, C.A.

ONTARIO

R. H. Langlois & Co., Chartered Accountants, announce the removal of their offices to 18 Temperance St., Toronto.

Hamilton and District Chartered Accountants Association

The Hamilton and District Chartered Accountants Association met with members of The Controllers Institute of America (Hamilton Control) at the Royal Connaught Hotel on April 5 to hear an address by Mr. Carman G. Blough, C.P.A., director of research of the American Institute of Chartered Accountants and former chief accountant of The United States Securities and Exchange Commission. Mr. Blough spoke on the subject of "Determination of Business Income" and discussed current proposals for deducting from income provision for depreciation computed on estimated replacement costs of fixed assets. The meeting was largely attended by members of both organizations and the audience included visitors from Toronto and Buffalo.

# News of Our Members

Mr. George M. A. Monteith, C.A. (Ont.), has been appointed sales manager and secretary-treasurer of Standard Paint and Varnish Co. Ltd., Windsor, Ont.

* * *

Mr. J. R. M. Wilson, F.C.A. (Ont.), addressed a joint meeting of the National Office Management Association, the Chartered Accountants Club of Western Ontario, the Society of Industrial and Cost Accountants, and the Certified Public Accountants Club of London in Hotel London, on March 21. He spoke on the annual reports of public companies.

* * *

Mr. Irvin Hunt, C.A. (Man.), has been appointed comptroller of J. H. Ashdown Hardware Co. Ltd., Winnipeg.

* * *

Mr. Maxwell Mackenzie, C.M.G., C.A. (Que.), has been appointed Deputy Minister of Defence Production in the Government of Canada.

* * *

Mr. Roland Chagnon, C.A. (Que.), has been elected to the board of directors of Dupuis Frères, Ltée, Montreal.

* * *

Mr. J. J. Macdonell, C.A. (Que.) addressed the Ottawa Chapter of the Society of Industrial and Cost Accountants of Ontario on March 15 in the Alexandra Hotel, Ottawa.

* * *

Mr. J. Armand Desrochers, C.A. (Que.), F.C.I.S., has been appointed general manager of National Breweries Ltd., Montreal.

* * *

Mr. Sidney Wik, C.A. (Sask.), has been named president of the Swift Current Rotary Club.

# The Students' Department

J. E. Smyth, C.A., Editor

## NOTES AND COMMENTS

"ALAS," we sighed and slumped in our chair, "we have only just repeated a point of accounting theory often enough to come really to believe it, when along comes someone with a different idea. Why, oh why, can people never let sleeping dogs lie?"

This was the burden of our sentiments the other day when we heard an opinion from a respected source that Reserve for depreciation should, after all, appear on the *right hand* side of the balance sheet *in the proprietorship section!* Having recovered somewhat from the initial shock, it now occurs to us that readers might be interested. Indeed, we even hope the proponent of this view will elaborate in an article of his own, soon. (If we interpret him badly enough he may be compelled to do so.)

Anyway, as we understand him, the main point is that the usefulness of most fixed assets does not decline nearly as fast as their book value. The book value declines gradually, gracefully, with the swelling balance in Reserve (or Allowance) for depreciation. The economic usefulness of a fixed asset on the other hand often does not decline steadily over the years of its life. Instead, most of the decline comes about in the last month of the asset's existence when management suddenly acquires a dislike for the thing and decides to sack it.

We are impressed with this attempt at realism. But it has some startling implications for Reserve for depreciation. If the reserve does not measure decline in usefulness until the last month of the asset's existence, it is *in the meantime* an appropriation of profits. It is a part of proprietorship until the dark month comes, and in the meantime the fixed asset will be shown at original cost on the left hand side of the balance sheet.

* * *

If we may be impertinent enough to interject our personal views at this point, we are not so sure that Allowance for depreciation account is really intended to measure decline in the useful life of a fixed asset. We have been thinking of it recently as a mere repository for costs which, sooner or later, must have been charged against revenue. One does not want to charge the whole cost of a fixed asset against revenue all at once, and if one does not do it *at all* he will end up with more assets on the books than there are in the business.

* * *

To change the subject, we have on our desk a beautiful annual report. There would be nothing unusual in this but for the fact that it is a corrected copy of one previously sent to shareholders this year. A transposition of figures was made in the text of the president's address to shareholders and employees, involving about a third of a million dollars. Shareholders have since been sent a new copy and encouraged to return the original by provision of a stamped self-addressed envelope. Presumably a horrible fate awaits the offending copies returned.

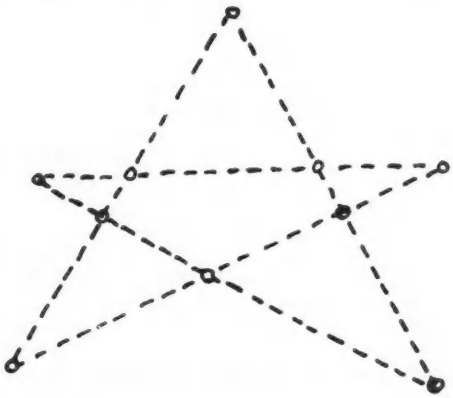
One thought the incident brought to mind was the wonder that this sort of thing does not happen more often. Another thought, less ponderous, was the recollection of a word we once saw in an accounting exercise. Our friend had been discussing the possible causes of a trial balance's not balancing and referred to the error one makes when one writes $8.90 and means $9.80 as a "transfiguration"!

## PUZZLE

A chartered accountant works in Toronto and commutes each day to his residence at Oakville. Ordinarily he leaves Toronto on the 5.00 p.m. train and his chauffeur meets him an hour later at the Oakville station and takes him home. One day he leaves Toronto instead on the 4.00 p.m. train (which also takes an hour to reach Oakville) without notifying anyone at home. When he arrives at Oakville he decides at once to go for a walk, realizing that his chauffeur will not come to pick him up until the usual time. Ultimately his chauffeur on the way to the station picks him up in the course of his walk and together they arrive home 10 minutes ahead of time. How long was the man walking before his chauffeur picked him up?

(*Contributed*)

## SOLUTION TO LAST MONTH'S PUZZLE



## PROBLEMS AND SOLUTIONS

Solutions presented in this section are prepared by qualified accountants and reflect of course the personal views and opinions of the various contributors. They are designed not as models for submission to the examiner but rather as such discussion and explanation of the problem as will make its study of benefit to the student. Discussion of solutions presented is cordially invited.

## PROBLEM 1

### Intermediate Examination, October 1950

*Accounting I, Question 5 (20 marks)*

*E* is the sole proprietor of a restaurant and writes up no records except his cheque book.

As of 31 Dec 1949 a balance sheet had been drawn up by a public accountant for *E* as follows:

ASSETS AND LIABILITIES

| | | | |
|---|---|---|---|
| Cash | | $1,000 | |
| Furniture and fixtures | $5,000 | | |
| Less—Reserve for depreciation | 500 | 4,500 | $5,500 |
| Accounts payable re food purchases | | 500 | |
| Accrued 1949 licences | | 100 | |
| Income tax withheld—employees | | 75 | |
| Accrued property taxes for two months | | 24 | |
| E capital | | 4,801 | $5,500 |

The analysis of *E*'s cheque book for January 1950 is as follows:

| | | | |
|---|---|---|---|
| Balance 1 Jan 1950 | | $1,000 | |
| Receipts | | | |
| Catering services | $ 193 | | |
| Meals | 5,645 | | |
| Candy and tobacco | 250 | | |
| Miscellaneous | 25 | 6,113 | |
| | | $7,113 | |
| Disbursements | | | |
| Salaries, employees (less income tax withheld—$225) | $1,600 | | |
| Tobacco, food, candy etc. | 3,000 | | |
| Rent | 300 | | |
| Gas, electricity and water | 90 | | |
| Laundry | 48 | | |
| Table and chairs | 300 | | |
| Printing | 25 | | |
| Owner's salary | 250 | | |
| Annual licence | 100 | | |
| Income tax withheld | 75 | $5,788 | $1,325 |

The bank reconciliation as at 31 Jan 1950 is as follows:

| | | | |
|---|---|---|---|
| Balance per bank | | $1,837 | |
| Deduct outstanding cheques | | 520 | |
| | | $1,317 | |
| Add: Bank service charges | | | |
| December 1949 | 4.45 | | |
| January 1950 | 3.55 | 8 | |
| | | $1,325 | |

Investigation reveals that the accounts payable at 31 Dec 1949 were $70 more than recorded and totalled $750 at 31 Jan 1950. Catering charges receivable at 31 Jan 1950 were $100. As at 31 Jan 1950, the inventory of food cost $290 and that of tobacco and candy $125. E estimates that at 31 Dec 1949, food on hand cost approximately $500 and tobacco and candy on hand cost approximately $75.

E commenced operations on 1 Jan 1949 and the furniture and fixtures were purchased at that time.

**Required:**

(a) Prepare financial statements for month of January 1950 reflecting the operating results and financial position as completely as possible.

(b) List the books which *E* should maintain for a simple bookkeeping system, explaining briefly the purpose of each.

## A SOLUTION

(a)

*E*

**Sole Proprietor**

PROFIT AND LOSS STATEMENT

for month ending 31st January 1950

| | | | |
|---|---|---|---|
| **Sales** | | | |
| Catering services | | $ 293.00 | |
| Meals | | 5,645.00 | |
| Candy and tobacco | | 250.00 | |
| Miscellaneous | | 25.00 | $6,213.00 |
| **Cost of Sales** | | | |
| Stock on hand 31st December 1949 | $ 575.00 | | |
| Purchases | 3,180.00 | 3,755.00 | |
| Less: Stock on hand 31st January 1950 | | 415.00 | 3,340.00 |
| Gross profit | | | $2,873.00 |
| **Deduct Expenses** | | | |
| Salaries | | $1,825.00 | |
| Rent | | 300.00 | |
| Gas, electricity and water | | 90.00 | |
| Laundry | | 48.00 | |
| Printing | | 25.00 | |
| Bank charges | | 3.55 | |
| Depreciation—10% 1 month $5,300 | | 44.16 | |
| Licences | | 8.33 | |
| Property taxes | | 12.00 | 2,356.04 |
| Net profit for month | | | $ 516.96 |

BALANCE SHEET

31st January 1950

| | | | |
|---|---|---|---|
| **Assets** | | | |
| Cash in bank | | $1,317.00 | |
| Accounts receivable | | 100.00 | |
| Stock on hand | | 415.00 | |
| Furniture and fixtures | $5,300.00 | | |
| Less: Reserve for depreciation | 544.16 | 4,755.84 | $6,587.84 |

| | | |
|---|---|---|
| **Liabilities** | | |
| Accounts payable | 750.00 | |
| Employees' tax deductions | 225.00 | |
| Accrued property taxes and licenses | 44.33 | |
| Capital | 5,568.51 | $6,587.84 |

*E*

CONTINUITY OF CAPITAL ACCOUNT

| | | |
|---|---|---|
| Balance at credit 31st December 1949 | | $4,801.00 |
| **Add:** | | |
| Stock on hand 31st December 1949 not previously set up | | 575.00 |
| | | $5,376.00 |
| **Deduct:** | | |
| Accounts payable not previously set up | $ 70.00 | |
| December bank charges | 4.45 | 74.45 |
| Revised capital account 31st December 1949 | | $5,301.55 |
| **Add:** | | |
| Net profit for January 1950 | | 516.96 |
| | | 5,818.51 |
| **Deduct:** | | |
| Drawings | | 250.00 |
| Balance at credit | | $5,568.51 |

(b)

**Daily Cash Record**

To record the cash received and disbursed through the cash register and/or till, with items properly classified.

**Synoptic Cash Book**

To record totals of daily cash record and to record bank deposits and bank disbursements.

**General ledger**

To provide description and balances of assets and liabilities, proprietor's equity and to accumulate the revenue and expense accounts under their respective headings.

**Simple Payroll Record**

To meet the requirements of the Income Tax Department, Compensation Board, and Unemployment Insurance Commission.

## PROBLEM 2

### Intermediate Examination, October 1950

*Accounting II, Question 6 (10 marks)*

Explain, for the information of the bookkeeper of a company, the correct accounting treatment of the following transactions:

(a) The company received on consignment a shipment, valued at a selling price of $4,000, and is to receive a commission of 10% on sales thereof. During the month of May cash sales of this consigned merchandise totalled $2,000, which amount is remitted to the consignor at the end of the month after deducting the commission earned on the sales.

(b) Royalties must be paid every six months to the authors of text books printed in the company's plant, based on the sales thereof for that period. Cheques to authors are issued in the sum of $3,575.

(c) The company entered into a contract with the Pulp and Paper Co. to supply them with paper at a specified quantity each month for six months commencing 1st September. The terms of the contract called for payment of 10% of the contract price on date of completion of arrangements of the contract and 15% at the end of each of the six months of the life of the contract. In respect thereof the company pays to the Pulp and Paper Co. the sum of $1,000 on 15th June.

(d) Employees of the company subscribed to $10,000 Canada Savings Bonds. These bonds were purchased from the bank by the company signing a note in the employees' names. Deductions from the payroll to cover these subscriptions are remitted each month to the bank. For the month of November $450 is deducted from the payrolls and remitted to the bank.

(e) An imprest petty cash fund is in operation in the general office. Vouchers for the month of November totalling $135 were submitted as support for the reimbursing cheque which is issued on the last day of the month. Included in the vouchers are — general office expense vouchers $35.75, vacation pay slips, $$44.25 and postage stamps purchase receipts $55.00.

## A SOLUTION

(a) Company should enter particulars of consignment shipment in memorandum consignment records but should not enter in books and records until sale takes place.

| | Dr. | Cr. |
|---|---|---|
| Cash | $2,000.00 | |
| Accounts payable — consignor | | $1,800.00 |
| Commissions earned | | 200.00 |
| The amount of the sales should be set up as a liability to the consignor less the amount of commission to which the client is entitled. | | |
| Accounts payable — consignor | 1,800.00 | |
| Cash | | 1,800.00 |
| To charge the consignor in the cash book with the money remitted to him. | | |

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(b) Royalties should be set up as Royalties payable at the end of each month after the sales records are balanced and charged to Royalties expense. Cheques issued in payment at the end of six months would be charged to royalties payable through the cash book.

| | | |
|---|---|---|
| Royalties (or royalties payable) | 3,575.00 | |
| Cash | | 3,575.00 |

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(c) The amount of $1,000 should be charged to Contract re paper purchases to which account the 15% would also be charged monthly. As paper was received the amount would be charged to paper purchases and credited to the contract account.

| | | |
|---|---|---|
| Contract re paper purchases | 1,000.00 | |
| Cash | | 1,000.00 |

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(d) An amount, $450, deducted for Canada Savings Bonds, will be credited to Savings bonds deduction. The amount of $450 remitted to the bank would be charged to Savings bond deductions, reducing the account to a nil balance. Subsidiary payroll records would be posted under the name of each member of the staff.

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(e) The reimbursement would be entered in the purchase record to the credit of Accounts payable. Administrative expenses would be charged with the expense vouchers, $35.75, and stamp purchases, $55.00 while wages would be charged with the vacation pay slips. The cheque issued would be charged to Accounts payable to clear the account. (Alternatively the cheque could be distributed directly to the accounts rather than setting up a payable item.)

| | | |
|---|---|---|
| Administrative expenses — general office | $ 35.75 | |
| Administrative expenses — postage | 55.00 | |
| Wages or salaries | 44.25 | |
| Accounts payable | | $ 135.00 |
| Accounts payable | 135.00 | |
| Cash | | 135.00 |

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## PROBLEM 3

### Final Examination, October 1950

*Accounting I, Question 4 (25 marks)*

The D. Co. Ltd. produces various types of kitchen knives. The blades and handles are purchased already processed, and the work done by D Co. Ltd. is merely the assembly of the two parts and the rivetting of the handles. The customers of the business are large retail stores ordering large quantities of specific types of knives.

While there is always a quantity of finished knives on hand, production is scheduled to fill orders received rather than for stock.

In addition to supplies of handles, blades and rivets, the company maintains at all times a small inventory of supplies and parts necessary for the upkeep of the machinery. Continuous inventory records are not maintained.

At the end of every month the foreman of the factory supervises the counting of blades, handles and rivets. The listing of these items is given to the accountant who, by comparison with the inventory at the end of the previous month and purchases during the month, calculates the quantities of blades, handles and rivets used during the month.

The blades, handles and rivets on hand are valued at the last purchase price and an entry is put through the books, debiting cost of production, and crediting purchases with the amount required to reduce the purchases account to the value of the inventory on hand.

The management is suspicious that the workers are either being very wasteful or pilfering substantial quantities of blades and handles. They also feel that too much time is lost each month taking inventory and that some better method of determining the costs of the materials used can be developed.

Required:

Outline a system of accounting for the quantities and costs of inventories which will meet the objections of the management. Explain how its operation would eliminate the weaknesses of the present system.

## A SOLUTION

1. *Perpetual inventory records*

**Physical inventory as starting point**

(i) Use as a starting basis, the physical inventory which is taken every month at D Company Ltd.

(ii) A separate card is prepared for each type of blade, handle, rivet, sundry supplies and finished knives. (Work in process would be negligible).

(iii) A detailed description is put on top of each card.

(iv) Quantities are entered thereon from the actual inventory.

(v) The actual unit prices are obtained from the accountant, estimated price being used on finished knives.

(vi) Unit price and value are entered on the cards.

2. *Ordering and receiving*

(i) The production chief will determine quantities to be purchased.

(ii) Pre-numbered purchase requisitions will be made out in duplicate by him to suppliers and a copy of the requisition sent to the accounting office.

(iii) As goods are received, a receiving report (pre-numbered) is made out in duplicate, notation being made of damaged goods, and a copy sent to the accounting office.

(iv) The accounting office compares the purchase order and receiving report with the actual invoice and enters them in the records, debiting materials accounts.

(v) The duplicate of the purchase invoice is sent to the stockkeeper who checks it with a copy of the receiving report and enters the quantities and values in his perpetual inventory record.

3. *Issues*

(i) As each order is received, a production order is written out and given to the factory foreman.

(ii) A cost sheet is also set up of the individual jobs.

(iii) The foreman will then make out requisitions in duplicate for materials needed on these jobs on pre-numbered forms, showing quantity and job number.

(iv) These requisitions are sent to the stockkeeper who will issue material and record the fact on his perpetual records, entering on the requisition the unit and total value obtained from the perpetual records.

(v) A duplicate copy of the requisition is sent to the accounting department. The accountant enters it up on the cost sheet for each particular job, charging work in process and crediting material inventory.

4. *Completion of knives*

(i) Employees' time is recorded by employees on special cards showing the number of hours on each process on each job.

(ii) The total time per these cards should tie in with the time per clock cards punched every morning and evening.

(iii) Payrolls are assembled by the accounting office and the amount chargeable to each job entered on the cost sheet.
The total is then posted to work in process.

(iv) Factory service is applied to the cost sheet at a pre-determined rate.
The total is posted to work in process.

(v) When jobs are completed, the unit cost is calculated on cost sheets by dividing units completed into total cost.

(vi) Completed knives are transferred back to stock room to await shipment.
The accountant makes an entry in the books charging Finished goods and crediting Work in process.

(vii) The completion of the goods is recorded in the perpetual inventory records.

5. *Advantages of system*

(i) It saves time of foreman and staff. No monthly physical inventory is necessary.

(ii) Values represented by material, work in process and finished knives can be readily obtained from the general ledger. Value of inventories is easily agreed with the control. The perpetual records maintained by the stockkeeper reveal inventory of handles, blades, rivets and finished stock. Uncompleted cost cards in the accounting office would reveal the inventory of work in process.

(iii) Differences between actual physical counts (periodic test) and stock cards will readily disclose carelessness and pilfering.

(iv) A properly approved purchase requisition and requisition for issue eliminates the possibility of employees helping themselves to the supplies.

(v) Job cost sheets will show the number of blades, handles and rivets issued and the number of knives completed as turned over to the stockroom.
Since the manufacturing process is merely one of assembly, any difference in the number of handles, blades, etc. issued and in the number of knives completed can easily be traced to its cause and corrected.

(vi) Accurate costing methods give a more correct picture of the cost of materials used as requested by management.

(vii) The system enables monthly financial statements to be prepared without taking a physical inventory.

(viii) It also enables management to plan its purchasing of raw material to greatest advantage, with no under- or over-stocking.